



Opalesque Round Table Series '11

TEXAS

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Editor's Note

The unexpected renaissance of Energy Investing

Energy is a volatile sector, which means long/short funds can work very well. At the moment, the U.S. is experiencing a booming oil drilling recovery - **there are more oil rigs drilling in the U.S. now than gas rigs for the first time since the early 1990s**, which is a fundamental change. In addition, **shale plays** in the Barnett Shale / Texas, Woodford in Oklahoma, Fayetteville in Arkansas, Haynesville in Louisiana, and Marcellus in Pennsylvania have created billion dollar investment opportunities.

Internationally, the whole resource play around shales and unconventional formations fascinates energy investors worldwide: plays are being developed in Poland, Argentina and China, and more shale resources are found in as diverse regions like Russia, South America, Australia, and India. The Opalesque 2011 Texas Roundtable dives deep into diverse and relevant topics such as:

- Where do energy investors see value?
- An update on Alternative Energy, and where is Natural Gas heading?
- What attracts institutional investors now to Energy MLPs?
- New activist strategies and searching for coiled spring type growth companies: How to invest in a low growth environment
- How to make money with tail risk strategies, asymmetric risk-reward trades and short-biased portfolios
- Regulations: How can managers meet the challenge of the new Form PF? How do hedge funds use expert networks?
- Have investors carried operational due diligence to excess?
- How being based in Texas helps local hedge fund raise assets
- Can U.S. hedge fund managers “understand” Europe? How do hedge funds navigate the macro variables that are driving the markets in the short term?

The participants:

1. Jerry Swank, **Managing Partner, Swank Capital**
2. Kris Kristynik, **Managing Member, Longhorn Management**
3. Phil Blazek, **Founder and Portfolio Manager, Blazek Crow Holdings Capital**
4. Ken Sill, **Director, TPH Asset Management**
5. Jorge de Cardenas, **Director, Kaufman Rossin Fund Services**
6. Peter Neems, **VP of Solutions Management for VPM/InvesTier at SunGard Asset Management**
7. Burke McDavid, **Partner, Akin Gump Strauss Hauer & Feld**

also discuss:

- **Important changes in Risk Management:** Traditionally, hedge fund managers were hedging through currency forwards, pairs trading to set up market neutral hedges, and through some derivatives. But now, managers have substantially increased using market derivatives and whole market hedges, i.e. volatility and variance swaps.
- **Going beyond Value-at-Risk (VAR):** For many years, people have used VAR as an overall measure of a funds risk. However, in many cases managers feel obligated to supply this number to an investor, but do not necessarily believe that VAR is a relevant measure or tool. With the help of technology, more managers started to include customized statistical risk factors in their risk management and reporting.

The Opalesque 2011 Texas Roundtable was sponsored by Kaufman Rossin Fund Services and SunGard and took place in October at the Akin Gump Strauss Hauer & Feld office in Dallas. We also thank Roundtable Series sponsor Custom House Group for their continued support.

Matthias Knab
Director Opalesque
knab@opalesque.com

Participant Profiles



(LEFT TO RIGHT)

Phil Blazek, Peter Neems, Ken Sill, Kris Kristynik, Jerry Swank, Jorge de Cardenas, Burke McDavid

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Jorge de Cardenas | jdecardenas@krfs.com | 305.857.6826
www.krfs.com | funds@krfs.com

Introduction

Ken Sill

TPH Asset Management

My name is Ken Sill, I am with TPH Asset Management, an energy investment advisory firm based in Houston, Texas. Our primary fund is a long/short equity fund; I am specifically responsible for oil services, coal, and alternative energy. Our team also covers the Integrated Oil Companies, Exploration & Production companies, Engineering and Construction companies, and some industrial companies with a large energy focus.

We launched our fund on March 1st. We have the infrastructure, people and processes to grow the fund significantly, and have plans to launch a long-only fund and potentially a fixed income product. We perform bottoms up, fundamental analysis on the companies we cover, and try to generate alpha returns by stock picking within each sector, and beta returns based on our commodity and macro outlook.

Kris Kristynik

Longhorn Capital

I am Kris Kristynik from Longhorn Capital in Dallas. Longhorn offers global equity hedge products and tail risk products, both in partnership as well as managed account formats. We employ a fundamental approach in order to pursue alpha at the individual security level and then offer a number of ways to express that alpha directionally, depending on the product. The business started in May 2006. We were seeded by Julian Robertson. Historically, our funds have been neutral to negatively correlated, and while our focus to date has been more on the short than on the long side, that will not necessarily be the case in all markets.

Jerry Swank

Swank Capital

I am Jerry Swank, my firm is Swank Capital. We are a niche asset management firm based here in Dallas. We invest in publicly traded Master Limited Partnerships (MLPs), which are U.S. energy infrastructure vehicles and for the past 10, 5, and 3 year periods have been a top performing asset class. We have a little under \$1.3 billion in assets across three different venues. We started out as a hedge fund manager in 2003. The hedge fund business is still our dominant business, but we also have used the research to go into the public fund space and the long-only business. We have a publicly traded closed-end fund, an open-ended mutual fund and other financial institutions have issued two publicly traded ETNs on indices we developed. Our third venue is a separately managed account platform for institutions and high net worth investors.

We have about 25 employees, all in our Dallas office. Our approach is bottom-up fundamental analysis. We strive to know every MLP company very well. On top of that we have an integrated risk management system wrapped around our portfolios; I believe most of us have learned this requirement after 2008.

Burke McDavid

Akin Gump Strauss Hauer & Feld

My name is Burke McDavid. I am a partner in Akin Gump's investment funds practice group. Our group consists of about 60 attorneys located primarily in New York, Washington DC, Dallas, and London. Our group services the alternative investment space, including working with both hedge and private equity fund managers as well as investors in alternative products.

Phil Blazek

Trammell Crow

My name is Phil Blazek. I manage a long/short equity fund in partnership with the Trammell Crow family office here in Dallas called Blazek Crow Holdings Capital. We invest in U.S. listed equities, primarily in small and micro cap companies generally with a market cap under \$3 billion. We employ a bottom-up research-driven approach and focus on fundamentals, speaking with each management team and knowing individual companies really well. Our best long ideas tend to be deep value, value or discounted growth companies in transition or out of favor, but with identifiable improvements or catalysts for positive growth.

Since we invest on the lower end of the capitalization spectrum, we tend to focus on technology and other industries such as internet, business services, consumer, industrials and healthcare, where innovation creates a significant competitive advantage for smaller companies and areas where that innovation can lead to growth in all types of market environments. We also invest in good cash flow businesses which are trading at attractive valuations.

Peter Neems
SunGard Asset Management

My name is Peter Neems from SunGard Asset Management where I focus on SunGard's VPM, which is a multi-currency portfolio management and accounting solution for hedge funds. The SunGard Asset Management segment provides a wide range of products and services, including specialized solutions designed to address the primary business requirements of the alternative investment market. These solutions include front office analysis, trading and portfolio management, risk management, specialist support for private equity transactions, independent valuations, and investment portfolio accounting, record keeping and reporting.

Jorge de Cardenas
Kaufman Rossin Fund Services

My name is Jorge de Cardenas. I am the co-founder and Director of Kaufman Rossin Fund Services. We are an independent full-service provider of specialized administration services to the global financial community. Born out of one of the nation's top CPA firms, KRFS delivers expertise in the complex areas of taxation, accounting standards and financial statement preparation. Clients worldwide rely on KRFS for startup, accounting and valuation, back-office outsourcing, investor services, treasury services, tax services, customized reporting and corporate services. KRFS has offices in Miami, Boston, Cayman Islands, New York and San Francisco.

Ken Sill

Our firm's alternative investment strategies are energy focused. I have been covering this space for 15 years. Energy is a very interesting space because it is not only driven by the economic cycle, and commodity supply/demand fundamentals, but also by geopolitics and sovereign government tax and regulatory policies. We see a lot of interesting opportunities in energy right now. For example, we are fairly bullish long-term on the prospects for oil. The industry has been experiencing rising capital intensity in its efforts to supply enough oil to meet growing global demand. The increasing difficulty in growing production is also reflected in higher commodity prices; higher prices are needed to balance out supply and demand by reducing demand, because it is almost impossible to move supply significantly in the short run. Therefore, on a long-term basis we see interesting opportunities in the oil field service and equipment sector as rising capital intensity and rising commodity prices drive higher upstream capital spending by the producers.

Getting oil out of the ground requires more intensive activity, more technology, and more capital. Just look at the areas where the industry is investing now to supply oil in the future – deep water, oil sands, tight shales, the arctic. These frontier oil plays are technically challenging, often in harsh environments, with little or no infrastructure. We also have a booming oil drilling recovery going on right now in the United States in regions like the Eagleford Shale and Permian basin in Texas, the Bakken Shale in North Dakota, and a growing play in the Utica Shale in Pennsylvania. There are more oil rigs drilling in the US now than gas rigs for the first time since the early 1990s, which is a fundamental change. U.S. activity will be more directly tied to oil prices in the future, which are driven by global demand, rather than North American natural gas prices, which tend to be more volatile, and hyper cyclical.

The oil market is a global market driven by rising demand primarily from the developing world: China, Brazil, other parts of Asia, and the Middle East where the population is growing. The fundamentals are very strong and economic uncertainty can create additional opportunities.

Energy is a volatile sector, which is one of the reasons we launched our long/short fund first. Energy stocks go down as fast as they go up, and usually have several double digit rallies and corrections each year.

So again, we see long-term value in oil services, and also in the E&P space. We watch value very closely on the producer side. What you are looking for are companies that have access to large reserves with below-average production costs, which should enable them to capture more of the economic value expressed in generally rising energy prices, while still generating positive cash flow during the almost inevitable periods of commodity price correction.

Natural gas is another area with a lot of uncertainty right now. We have a gas glut in North America, but clearly we will be seeing more global demand for natural gas over time. One gas demand driver will be reduced reliance on nuclear power in countries like Germany and Japan. If more industrial countries decide, like Germany, to cut back on their use of nuclear power, the only viable alternatives are hydrocarbon-based fuels in the near term, which come down to coal, which is very dirty, or natural gas, which is much cleaner.

We have also looked at and invested at times in alternative energy. However, the problem with alternative energy in today's market is that most projects are not economic without government subsidies. It is hard to see how those subsidies will be sustained in a period where everyone is looking for ways to cut spending. The stocks are not attractive and are almost impossible to short. Of course, companies that actually have an economic model that works without government subsidies are interesting, but in general, the space is un-investable right now.

Ken Sill



For example, within the solar sector, thin film solar is a very interesting technology, but it is going the way of the microprocessor – meaning there is too much manufacturing capacity. The Chinese have entered the manufacturing game on a very large scale. The result is rapidly falling prices. As government subsidies start to roll off in Germany, Italy and other places in Europe which have been some of the biggest solar markets, you also have questions about demand. Rising capacity combined with a weak demand forecast keeps unit pricing under pressure for the manufacturers. Project integrators that are doing big industrial scale projects may be a better place to invest, but the whole space has been in free fall.

You are seeing the same dynamic in the silicon-based solar energy and the wind energy business. Again, the Chinese have decided wind is a core area in which to be involved. There are at least three large wind turbine manufacturers that have been capitalized in China. While demand is keeping up, prices are falling. This is a market that traditionally Vestas has dominated and GE has been very big, but the margins are being squeezed, and you are seeing a reflection of that in the wind turbine stocks, which have been under pressure most of this year.

Matthias Knab

Do you find more short than long candidates within alternative energy at this moment?

Ken Sill

Yes, you can actually short them. However, for a lot of of these alternative energy companies it is almost impossible to borrow shares to short.

Matthias Knab

It seems that even for you as an energy fund there is not a lot of alpha to extract from the alternative energy sector?

Ken Sill

This is correct. For now, even tight pair-trading is tough because the market is making a very negative bet in that sector right now, shorting the good companies, (because those are the only shares available to borrow) and taking down the entire sector. Alternative energy companies also tend to be smaller cap companies, which do not necessarily have strong balance sheets. It is an area where it is hard to create alpha, and the beta has been one-way recently.

The coal sector on the other side has become very interesting. The Chinese are going to use a lot of coal, because they need it to generate more power. China is a coal-based economy. Approximately 80% of their electricity generation comes from coal right now, and if you look at their long-term plans, that percentage is projected to remain relatively stable despite huge forecasted electricity demand growth over the next 10 or 15 years.

New rules in North America are changing the mix of coals to be used for electric power generation, and when and where you will burn them. This is creating opportunities for low cost, low sulfur coal. There will also be losers in this transition, principally high cost producers of high sulfur coals. Metallurgical coal producers are also very interesting. Steel production capacity has been rising, driving higher demand for met, or coking coal. However a recession could put a significant dent in demand projections. For an investor, coal offers interesting opportunities on both the long and the short side.

Of course, coal is facing tremendous environmental issues, but it is not going to be replaced anytime soon. For example, even if we sell more and more electric vehicles, where is the power going to come from to charge them? It is great to talk about electric cars, but you have got to generate the electricity somewhere. Coal power stations tend to be large, single point sources of power. Large scale plants are more suited for installing the technology that reduces their emissions, making coal-fired power cleaner than it has been historically. The problem with dirty coal is related to the grandfathering of older plants. I think in the U.S. and in Europe, the lawmakers are starting to change that. By the way, that is also likely to create more demand for gas-fired electric generation.

Internationally, the whole resource play around shales and unconventional formations has become quite fascinating. We see plays being developed in Poland, Argentina and China. There are more shale resources around the world, Russia, South America, Australia, and India. These are very service and capital intensive resource plays, and therefore are very interesting investments from the long side of the oil service space. But, this also tends to be cyclical business. The equity markets appear to be saying we are going into a down cycle, which could become a self-fulfilling prophecy. The more concerned people get, the more likely they are to reduce spending, reinforcing the down trend. Right now oil prices are high enough to support a lot of drilling activity, but we are watching them closely.

We also find North American refining interesting right now, because the crack spreads are huge owing to supply disruptions in places like Libya and changes in the way oil is moved around the world. For the first time since probably the 1960s, oil production in the US is growing, and owing to a lack of export pathways, mid-Continent refiners are seeing great margins. Until pipeline bottlenecks are relieved, they can refine cheaper WTI-based crude into products, primarily diesel, where prices are supported on a global level by high Brent prices.

I mean who would have ever thought of such things? If you had to told me 15 years ago that the US would have some of the cheapest oil and the cheapest natural gas in the world, I would have said you were a lunatic, but that is where we find ourselves right now. WTI has a \$20 to \$25 discount to Brent, depending on the date, which gives US refiners a nice advantage when they can refine cheaper WTI and export higher-priced finished products to other markets.

Ken Sill



Jerry Swank

Like Ken's fund, we operate in the energy sector and we also take advantage of the trends there which are also drivers of our growth, but our niche is not directly related to commodity prices of oil and gas.

The companies we invest in provide the basic energy infrastructure in the United States: pipelines, storage facilities, terminal and processing plants. Starting in 2004 or 2005, our business saw a huge surge driven by the development of the natural gas shale play and related natural gas liquids.

Our problem isn't that we don't have enough of this infrastructure in the United States, it just it is in the wrong place. We started to build out the energy infrastructure here in Texas, just a few miles west of us in the Barnett Shale; followed by the Woodford in Oklahoma, the Fayetteville in Arkansas, the Haynesville in Louisiana, and now the Marcellus in Pennsylvania. All these shale plays have all created billions of dollars worth of investment opportunities for our Master Limited Partnerships.

According to some recent estimates, over \$250 billion of new capital will be needed in that marketplace over the next twenty years. So, natural gas has driven the build-out, and has built the roadmap for these companies. What happens is the companies are set-up as partnerships - they pay out a majority of their cash flow - so they have about 7% current yields, and they raise their distributions to about 6-8% a year. A lot of people say they would like to make mid-teen kind of returns - our companies deliver that. You start with a 7% cash yield and additionally receive a growing distribution.

How does the situation look like going forward? In my view, and I am not alone here, I think the growth opportunities going forward are the best we have seen since I have been in the business. Rich Kinder, who runs the second biggest MLP in the space, and is seen by some as a thought leader in the space, claims that the opportunities today are the best he has seen in his 30 years in the business.

Again, shale technology is the big thing now to the oil business. I gave a speech a year-and-a-half ago, and I felt like

Jed Clampett when I said we need to look for oil, but it has really been true. So, we have seen the growth of the Bakken Shale in North Dakota, and then we see growth in the old Permian Basin which is one of the oldest producing basins in the United States. All of a sudden these guys who were sitting on the little stripper well doing ten barrels go “Oh golly, I have this Wolf Camp zone where I can do shale oil production and get rich again”.

Midland, Texas is very rich again, in case you have not been there. In fact, we know people who had to move from Houston to Midland and had to pay up for houses, if you can ever believe that. Also the Eagle Ford shale in South Texas has become a kind of boom area.

Coming back to our Master Limited Partnerships, they are the finance vehicles to build new pipelines, terminals, and facilities to get the oil and the natural gas liquids to Cushing, to the Gulf Coast, and Mont Belvieu, which is near Houston. Billions of dollars of infrastructure investment will be allocated over the next few years in a very visible and very profitable format.



As Ken and other industry analysts will know, you won't find one exploration and production (E&P) company's quarterly statements where they are not complaining about the lack of infrastructure. Fact is, the infrastructure cannot be built fast enough. When oil is being carried on rail from the Bakken to Cushing, from Oklahoma to St James, Louisiana for \$7, \$8 and \$9 a barrel, you know how unprofitable that is. We have this glut of oil in the mid continent in Cushing, but we don't have enough pipeline capacity to get it to the Gulf Coast. All of those things represent incredible opportunities for the MLP market.

Jerry Swank

Matthias Knab

Who is a typical investor in energy MLPs, and what are some latest trends from the investor community there?

Jerry Swank

Historically, 70% or 80% of the investors have been retail. We have to keep in mind that just five years ago this niche consisted of say seven stocks which you could hold in your broker's account.

We began to see new inflows from institutions starting in 2010, and I assume this will develop to be a major trend. For example, some state funds may be getting 4% on their corporate bond portfolio, if they could sell those and buy energy MLPs, they will pick up 200 or 300 basis points more, plus the growth of those distributions. In the last few weeks, two of the very large institutional pension and endowment/foundation consultants have written big position papers basically taking this asset class to their investors.



Jerry Swank

Matthias Knab

Why have the institutions and consultants not come in earlier, given the notorious underfunding of pensions and the general low yield environment?

Jerry Swank

One reason is certainly that MLPs are partnerships with distinct tax characteristics, they are not corporations. For example, there is a tax issue called UBTI, which we do not have the time to start talking about it right now, let me tell you... So, for some institutions they do not want to touch UBTI, they can structure their investments to get around it. But some institutions will not be interested at all.

Size used to be a consideration too - when I started the business in 2003, this was a \$30 billion market cap. MLPs' market cap is now at \$300 billion and are growing strongly. I guess we stand where the REIT business was in 1999 or 2000, we are finally large enough for institutions to invest.

Matthias Knab

That was a great update on energy and MLPs. Kris and Phil, what do you see happening in your fund sectors?

Kris Kristynik

We tend to be opportunistic in our investments. However, since late 2009, we have taken the view that the recovery that has been manufactured by governments globally is largely not self-sustaining, and that more problems have been created than solved, both in the U.S. and the rest of the world. This perspective has significantly impacted our view of the risk in owning equities broadly. We have tended to view market rallies as reflective of liquidity and technical conditions, not sustainable improvements in company fundamentals or business conditions. In our view, most of 2011 has generated more evidence supporting that position. The policies and interventions seem to be reaching their terminal endpoints which should ultimately reveal the scope of the underlying problems and create real opportunity for short sellers.

We run several products both in partnership and managed account format that are directed to help people navigate an environment that we believe will only continue to get more difficult. We have managed equity hedge products and managed accounts since inception and in 2009 developed tail risk strategies specifically directed toward capitalizing on an inevitable hard landing in China.

Our process aims to opportunistically exploit what we believe is the disconnect between investors' perception of corporate earnings power and what we think sustainable earnings power really is. In the current environment, we believe earnings have been dramatically supported by global government stimulus. For example, over 20% of US disposable income comes from transfer payments. This revenue support combined with subsidized cost of capital and tax levels have generated record margins. We foresee significant headwinds to earnings at a time when margins are at a record and valuations are not compelling.

Broadly speaking, investors are capitalizing perceived earnings power that is not sustainable given its dependence on trillions of dollars that governments have thrown at the system. Despite the occasional rallies which create false hope for investors, we believe this is the initial phase of a long process of normalization of margins, cost of capital, government subsidized growth and valuation.



The focus on problems in China is now very popular. However, when we initiated strategies dedicated to China in 2009, it was not popular to view negatively their massive growth stimulus, which led to growth in money supply and bank balance sheets at astounding rates.

Now, there are more negative headlines in the news highlighting the bubble-like nature of Chinese credit growth, but we believe there is still a significant amount of risk and opportunity for us to make money. We tend to focus on individual stocks we think are subject to those risks, whether they are in China, or whether they are derivative plays. As well, we employ other strategies to add leverage to our thesis.

Kris Kristynik

Matthias Knab

So are you net short at the moment?

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Kris Kristynik: Yes, we are net short. Market strength over the past couple of years has clearly created a lot of great short opportunities, and we believe the best risk-reward is on the short side until global bailout excesses are normalized or valuations decline significantly or both. However, it is apparent governments globally are not ready to throw in the towel, and investors are still largely hopeful things work themselves out. This dynamic creates a tremendous amount of volatility and results in a great trading environment that is generally very difficult for both long and short investing. However, I do think the trend has changed and that the most money will be made on the short side in the intermediate term.



Phil Blazek

We tend to be opportunistically net long with a focus on those sectors and stocks of the U.S. markets where we believe there are good values and good quality companies, which for various reasons have suffered from some kind of dislocation. Our goal is to generate attractive risk-adjusted returns by exploiting market inefficiencies on both the long and short side.

We are in a low growth environment - we have had a cyclical upturn in the last couple of years, and now it is coming back to a lower growth trend. Therefore, we like to look at industries where there is technological change - that could be software, med tech or similar fields, or other areas impacted by innovative business models.

We also see in the U.S. how certain change agents or activist shareholders create opportunities. For example, CEOs that come from larger companies and buy a personal stake in small or microcap firms have their interests more closely aligned with the other shareholders. Another example would be if a company has certain patents or customer relationships or an install base, but are not making good use of those resources. If such companies miss a few quarters and become attractively valued, then oftentimes you see change agents come in and attempt to create value there. Examples might be changing the cost structure, bringing in a new management team, pursuing new product lines, and perhaps eventually selling the company or simply getting the company back from no growth to a value path.

We see more examples of secular versus cyclical in the advertising industry. Think about the billions of dollars of revenue that a Groupon or Google has shifted to their side in the last few years - the losers here are likely the older, traditional forms of advertising like radio and print. While some of those may have seen a cyclical uptick in the last few years, they are actually in secular decline. As investors, we really have to be disciplined - you might find some of those assets trading at low valuations at the top of a cycle, but then you cannot pay too much when taking a position, or consider them as actual shorting opportunities.

There is a propensity for U.S. investors at the moment to flee small caps, and especially micro caps, for greater liquidity. After 2008, hedge funds sought to be very liquid, they want to be very nimble, and they want to be able to get in and out of stocks quickly. This has created tremendous opportunities in micro caps, where we recently saw valuations fall close to 2008 levels. You can find companies trading just above cash on their balance sheet or under four times cash flow. We like to take advantage of those opportunities, which are often below the radar of other investors.

A second dynamic in our portfolio includes a number of strategic and financial buyers who are looking to buy growth during this low growth environment. Financial buyers still have not put most of their resources to work, and they continue looking for opportunities. Strategic buyers are also looking to buy innovative or pure play business models where a company has taken advantage of a certain market niche. We often see a stock trading at four times EBITDA for an extended period of time, and if public market investors are not interested in this less liquid, smaller cap universe, financial or strategic buyers come in. We have held over a dozen companies in our portfolio that have been acquired for premium values in the last 2 years.



Phil Blazek

We believe that in general, the U.S. markets remain volatile. You will often see investors selling down small cap stocks for irrational reasons, especially following a macro event, or if the company has missed its last quarter for example.

Investors can find many pure play, innovative companies in the small and micro cap arena that are good engines of innovation in the United States, and who sell their products and services on a global basis. As long as you are disciplined with the values that you pay, in many cases, these good companies' stocks will either eventually increase in value or a strategic or financial buyer will buy them.

Peter Neems: At SunGard, as with many firms, we have seen a marked increase in the demand for risk management and monitoring tools. For many years, people have used Value-at-Risk (VAR) as an overall measure of a funds risk. However, recently we have found that people feel obligated to supply this number to an investor, but do not necessarily believe that VAR is a relevant measure or tool. We have seen the focus shift towards a holistic view of portfolio risk and exposure across sectors and other customized criteria. The trend is increasingly towards factor based risk, specifically statistical factors.

Typically, when people mention factor based risk they think about predefined factors, such as the risk associated with the energy industry. However, with statistical factors you can actually develop solutions that allow clients to define their own risk factors.

For example, you can determine 'X' amount of my risk is corollary to the government decisions on energy policy. The enhanced models not only give you all the capabilities of a standard market analysis, but also the ability to do your own individual, customized analysis. In doing so, firms feel more comfortable that they have a better handle on their risk exposure, which they can then use as a competitive advantage. Thus the technology allows investment managers to better monitor risk, which in turn increases the comfort level of their investors that their investments are protected.

Also, some investment firms don't just look at the risk, but also at portfolio construction. A lot of investment managers may feel that they are very good at identifying the right companies for investment, but at the same time they do not necessarily know how to hedge these investment strategies or how to weigh the different investment options. How do you protect your bets, your clients and your firm in that case? There is a large demand where people ask SunGard VPM to help them optimize a portfolio to minimize risk in certain sectors.

Peter Neems



Matthias Knab

Jorge, which developments within hedge funds and the alternative investment industry can you observe from a fund administrator's perspective?

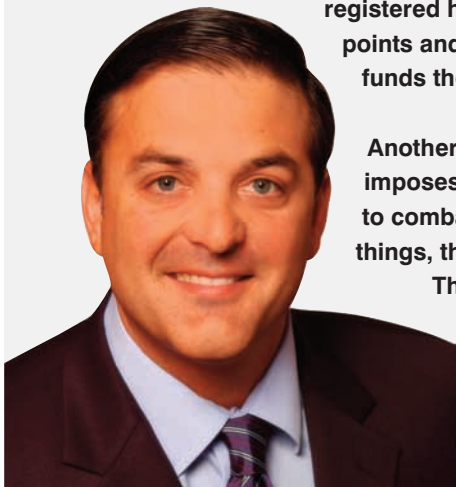
Jorge de Cardenas

From our perspective the last 12 months have been very interesting for the hedge fund industry. Two of the biggest developments or trends that we see as administrators are the continued institutionalization and regulation of the alternative investments industry, and the need to prepare our clients to meet these requirements. Ironically, at the same time that we are seeing one of the most demanding environments for hedge fund managers, we are also seeing a lot of new fund launch activity.

As institutional investors continue to increase their allocations to hedge funds, they are demanding more from hedge fund managers, and managers are demanding more of their administrators. One example is increased transparency in the form of daily reporting independently provided by KRFS directly to these investors. This reporting includes P&L,

counterparty risk, independent verification of valuations and FAS 157 levels, independent verification of the existence of assets, etc. Another continuing trend is funds are moving to a daily operational model, i.e. daily trade entry and reconciliation of all financial accounts. Additionally, we have noted less stringent lock-up and redemption terms on recent start-ups as capital is harder to attract and investment strategies are generally more liquid.

The regulatory landscape is undergoing dramatic change as a result of the financial crisis. For many managers the SEC-registration deadline of March 30, 2012 is quickly approaching. There is discussion that FINRA will become the regulator for hedge fund investment advisors. The adoption of Form PF (was unanimously passed on October 26th subsequent to this Roundtable) will be a huge challenge for the industry. This form is a 44 page document that registered hedge fund advisors will have to file with the SEC. It has close to 2,000 data points and incorporates both information about the Investment Manager and the Funds the funds they advise into one form.



Another regulatory challenge is FATCA or the Foreign Account Tax Compliance Act. It imposes more regulatory requirements on hedge fund managers. This Act was designed to combat tax evasion by U.S. taxpayers using offshore vehicles. It requires, among other things, that offshore hedge funds to enter into an agreement with the IRS by June 13, 2013.

This agreement obligates the fund to: implement due diligence procedures aimed at identifying US tax payers; to report annually to IRS regarding US account holders; and to withhold and pay to the IRS 30% on any payments to non-participating foreign financial institutions or persons.

Jorge de Cardenas

From a business perspective, we have seen a lot of emerging manager activity, with forty-six (46) new launches in 2011. We have also had 28 conversions from other administrators in 2011. At the moment, we have close to 25 funds in the launch pipeline. So, we see a lot of demand, perhaps due to the Volcker Rule or for other reasons. One item to note is that many of these launches are being seeded with less capital than we saw in years past.

Peter Neems

A significant portion of our sales pipeline and identified opportunities are with start-up firms. Jorge mentioned transparency, which is also a big demand we are seeing from hedge funds. Functions like back office management, operations, and oversight have become a vital part of a hedge fund's business, even in start-ups. The firm's executives are dealing with a growing demand from investors for information on the firm's operating infrastructure, satisfactory risk data and these types of controls to properly protect their investments. No investor wants to be the victim of another Bernie Madoff. I would estimate that in the past two years 40% of the deals we see have been with start-ups. And to Jorge's earlier point, they have been start-ups lower than \$500 million in AUM.

If you look at the SunGard VPM business model two or three years ago, we did not have a pricing model for funds under \$1 billion, because these firms never considered bringing technology in-house. Technology from an external solutions provider was not something firms of this size needed. Start-ups viewed technology and solutions like those from SunGard as more of a luxury only for the larger funds. Now, because of recent actions by some firms, along with the resulting increase in government regulation, we have seen investors turn that "luxury" into "necessity". Due diligence questionnaires from investors that were five pages long just two or three years ago have become hundreds of pages long, with a strong focus on the operational oversight of their investments.

Prior to the recent economic crisis and regulatory changes we had many clients using our systems to administer their own entities, which is no longer acceptable. Investors now demand



Peter Neems

that every client must have a third party administrator. And in most cases not only must the firm have an administrator, but they must also have a back office accounting system to ensure the appropriate checks and balances are in place, along with comprehensive reporting tools.

Technology, like SunGard VPM, plays a vital role in meeting these evolving investor demands. We recently talked to a prospect that was launching with \$65 million under management. Their portfolio manager wanted our back office systems to meet investor demands and help to appropriately position the fund for growth. This is something we would never have seen just a few years ago.

Burke McDavid

I would agree that some of the clients that are performing well are those in the credit space.

Several years ago there was quite a boom of commodity funds like oil and gas trading funds; those seem to have leveled off performance-wise and in respect of new fund formations.

We continue to observe a lot of interest from new market entrants and existing clients for new fund launches. These tend to target smaller asset sizes. Those that are launching are putting more time into thinking about their strategy and goals and are doing a better job of matching those to their fund's terms. As compared to pre-crisis times, there is a more thoughtful process involved in designing new funds. For example, I think fund sponsors do a much better job of matching investor liquidity terms with the fund's liquidity profile.

While the beginning of 2011 felt like we had more of an uptick in new fund formations, it seems like towards the end of the year the start-ups have slowed down as it continues to be a very challenging fund raising environment, particularly for new market entrants.

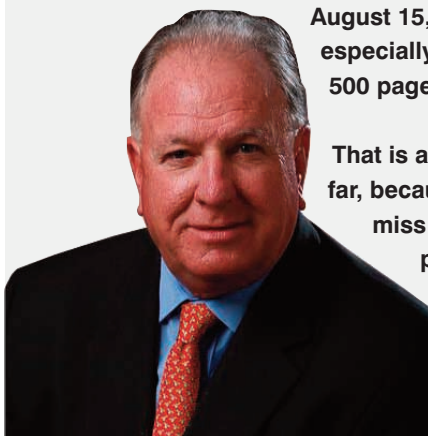
Jerry Swank

I want to come back to the topic of changes around due diligence.

When a fund of funds or family office came in to see us in 2004 or 2005, they would spend 90% of their time on investment assets, investment process, investment people, and then they would ask you who is your prime broker, who is your law firm, and that was kind of it. Today, it is completely the opposite: 70% to 80% is about operational due diligence not only transparency, but who are all of your service providers? You have to have independent people. They go through the trade process, through confirmed trades - you have to have an integrated trading system like Eze Castle, Charles River, or something like that, that is another check.

The process has gotten dramatically longer and dramatically more personal. They ask questions like what I did on August 15, 1982 at 2:30 in the afternoon, it has gotten to that state. And on the RFPs, especially from large organizations, the requests have gone literally from five pages to almost 500 pages.

That is a challenge for a lot of businesses like ours. I think the process has gone actually too far, because a lot of the questions they ask now are completely irrelevant. Now I feel they miss out on the investment process by focusing totally on the operations side. The process is really intense. We had to hire two people just for this.



Jerry Swank

Ken Sill: We launched on March 1st and just went through the capital raising process. We were out raising money from November through March. We found a clear bifurcation of the investor universe.

We have a strong institutional backer in Tudor, Pickering, Holt, which is an energy investment banking firm. We received good inflows and have now over 70 investors: individuals, family offices etc., many from Texas. They are comfortable with our firm, because they know who we are, where we came from, and we found we can work with that constituency of the capital markets.

But when you look at funds of funds or other capital allocators, they are looking for a track record, and with the current market volatility they have been reluctant to invest. They have expressed interest, but are just not making many new allocations.

Ken Sill



My observation from being both on the sell side and now on the buy side is that the infrastructure required to launch a new fund is much greater than it used to be. We have auditors, lawyers, Eze Castle, accounting systems, multiple prime brokers, strong reporting systems and so forth. My last firm was the proverbial fund manager from a well known hedge fund who took his trader, hired a CFO, got some seed capital and started trading stocks.

That is not how you start a fund today. You need to have all of the bells and whistles, and need to build quickly to a larger asset base in order to spread those costs around. With each fund you need to do audits, you need to be able to cater to private clients with separate accounts, and demands for greater transparency and more reporting. This drives administrative costs much higher than they used to be. Like Jerry said, these things also become a time burden. If the portfolio manager tries to deal with these issues, he will have to take time away from portfolio management. Nobody has enough bandwidth to do both. Funds need somebody to take care of this growing administrative function, so the investment team can focus on investing, and these added resources drive up costs.

Matthias Knab

At what asset size can a hedge fund now be profitable or break even?

Ken Sill

Obviously, we are in an absolute return business, so if you have positive investment performance you break even more quickly through the performance fee. However, I would say you probably need to have \$250-300 million under management to cover the back office, accountants, lawyers, software and all the other costs associated with being a stand-alone fund. It could also be much higher than that, depending on your fee structure.

Peter Neems: We have seen management fees getting lower and lower; the “2 and 20” is gone. So, unless as Ken said you are making good returns, you need to rely on that 1% or less management fee to run your business and pay your bills. As a software vendor we have made significant adjustments to our pricing models over the past few years to adjust to changes in conditions in this market. For example, we modify our pricing to give customers a discount for signing longer-term contracts. SunGard is taking a bet that these emerging managers are going to succeed and grow their businesses, and we will be a key partner for them in their future growth plans.



Of course, this pressure to drive down fees comes from the investors. It is not unusual for us to be required to meet tight deadlines to get our software installed and train the operations manager, so the manager can then demonstrate the software to their investors. The investors require this type of confirmation, or they will take their investments to another firm.

Our software and training empowers the operations managers and leaves investors confident that they are able to keep track of their money, positions and risk parameters. However, I do agree that the pendulum may have swung a bit too far towards that other direction. Having to deliver all those requirements in order to launch a start-up or in order to get institutional money has almost put a virtual ceiling on the growth of these managers and businesses. They cannot afford to manage the technological infrastructure, however, they need these systems to attract the institutional investors. Maintaining a traditional technology infrastructure today is a monumental challenge. Higher security and compliance standards coupled with increased pressure to reduce operating costs and conserve resources make responding to newer and more complex business opportunities much more difficult, with innovation and agility even more challenging.

In response to this we have started providing hosting services for our applications. We have gotten a very positive response to this in the market and the majority of our new sales, of all sizes, are electing to have their technology hosted because it means reduced IT expenses, virtually hands-off maintenance, and increased value for their organization. By removing the burdens of hardware, software, databases, and other technology components, our clients using hosted solutions can focus on the business at hand and better meet their most demanding growth objectives.

Jorge de Cardenas

I think that the minimum asset levels may vary depending on the business model and the investment strategy of the manager. As previously mentioned, we have seen a surge in start-ups and, in speaking with these clients, each is approaching this challenge in a different way. Some are obtaining sufficient capital in their funds to cover their overhead on day one. High net worth and family offices are two examples of early sources early capital that we have witnessed.

Others may not be looking to raise this level of capital initially but they are viewing their business from a long-term perspective where they are willing to invest their future by subsidizing overhead and even fund expenses, the goal being to build a solid track record and operational infrastructure and then begin raising capital.

KRFS also supports several new pooled vehicles which are playing an important seeding role by allocating capital to emerging managers through managed accounts or direct investment. This structure can be a win/win as it has a “seeding” component for managers at a time when capital is tight and it provides access for larger investors to emerging managers and potentially higher alpha.

Matthias Knab

Have you also slashed your fees like SunGard for some of their products, or do you offer other incentives for smaller funds?

Jorge de Cardenas

The fact that many of our large clients today started from a small capital base is a constant reminder that the growth and success of our business in the last decade is in part attributable to our willingness to take on emerging funds. We have always been sensitive to funds that are just starting-up and are usually able to come up with some creative ways to help out emerging managers. From a cost perspective we can be competitive due to our continuous focus on processes automation and workflow. This technological focus allows our qualified staff to spend more time reviewing, advising on complex issues, etc because many of the more mundane tasks have been automated. We can't, and won't allow fee pressure to affect service or quality, so outsourcing or cutting corners to compete on price is out of the question.

Clearly, this “macro driving the bus” situation we are going through now makes our lives almost

Jerry Swank: I have a question which has started to come up in a lot of our discussions with other firms too, and I am curious how the other managers in this room go about this. I would say that most of us asset managers now find ourselves in a situation where our markets have become, more than at any time before, influenced by political developments of 17 countries in Europe, which probably most of us can't even name.

We were brought up and trained as economists, finance experts, accountants, traders or portfolio managers, but I am not sure any of us would have ever said one of our core skills needs to be able to analyze the Prime Minister of Slovakia - what will they decide in respect of the Euro? How do you folks handle this geopolitical risk running your portfolios, when you buy stocks or just talk to the investors?

Jerry Swank



Kris Kristynik: I think you are right; the number of macro variables that are driving the markets in the short term right now is very high. But the news flow out of Europe just reflects an ongoing drawn-out process of normalization of policy excesses I discussed earlier. While we cannot predict the short term twists and turns, an awareness of the unknowables in, say, Europe or China, help give us context on what risks may or may not be worth taking at any given time. And while we cannot know, for example, whether the Euro will exist or not in the long term, we can analyze whether certain banks are insufficiently capitalized and overvalued given the risks.

Our goal is to find some asymmetric risk-reward in our favor at the individual securities level. As we go through stocks and through markets, our view is the vast majority of companies' earnings profiles and valuations do not sufficiently discount what we think all of the risks are. While this healthy appreciation of macro risk may diminish our appetite for pure long stock picking in the short and intermediate term, it is a key component to risk management in a volatile, headline-driven time like we are in now.

Kris Kristynik



Ken Sill

impossible. I am exaggerating, because I am still working at the fund, but this is a tough market for picking stocks and generating alpha given the high degree of correlation in the market. So, how is our firm managing the current situation? We have our heads down in the details, visiting companies, studying the fundamentals. Obviously, in this type of environment you need to be very cognizant of where trough values are –

One of the reasons I like the oil business is that oil is a depleting resource. You have to keep spending money to maintain production, and replace the oil that is consumed, and this is getting harder to do, not easier. For oil demand to drop significantly, you need a really nasty macroeconomic situation. So, the oil business has an almost natural hedge against an extended cyclical downturn given the lack of spare oil production capacity. If the industry cuts spending, production is going to drop 3% - 5% or more each year. That is a nice back stop for a long term investor, but for now, the macro situation has us focused much more on the near term, as we wait for company and industry-specific fundamentals to eventually overcome the strong correlations driven by macro concerns.

Our fundamental investment process starts with alpha (stockpicking) at the individual stock level. Everybody in the firm has a group of stocks to cover, and we rate them in a continuum from a strong buy to a sell within a totally balanced portfolio. If you are generating positive returns on your alpha ideas, you are picking stocks well regardless of the market direction. We can then tilt the portfolio long or short depending on our view of market direction and energy fundamentals.

This model was working very well until September and October, when correlations rose, and the stocks stopped reacting to fundamentals like they typically do. There were days when stocks reacted poorly to good news and other days when they were up despite bad news. The volatility of the overall market makes me nervous. The market is not supposed to go up and down 1-3% a day. I can live with that in energy, because it is typically a very volatile sector; but it is unnerving to see volatility at these high levels for the overall market.

Similar to Kris, I don't think we have a better idea about the macro outlook than anybody else. We have tightened the portfolio exposure, taken down leverage, reduced our beta, or directional exposure, and are relying more on our alpha. When the stocks start behaving more normally, by reacting to news and earnings in a way that seems more rational, or at least more consistent, then you can size the book up and take on more directional risk.

But let me tell you that just as this situation causes stress to a veteran like Jerry, who asked the initial question here, it compounds the pressure you feel as a start-up fund where you need to produce results to attract investors. Phil talked about small and microcaps and the lack of liquidity that can happen in that segment. They got thrown under the bus faster than anything in the recent downturn, despite some really compelling investment opportunities. So, when you need to stay with liquid stocks, your investment horizon tends to become much shorter.

This volatility does create opportunities for those with longer investment horizons, and is why I am excited about the long-only fund we will be launching. You can express ideas in a long only fund that you know will germinate over time, regardless of near term market volatility.

Ken Sill



we look at ratios like price-to-book, price-to-replacement cost, price-to-NAV that the stocks trend to in most extreme downturns. When you can buy long lived assets at a significant discount to their cost, and you know the demand for the assets will eventually rebound, and you have seen these types of assets double or triple in value over prior cycles, at some point you just have to buy something, knowing you will make outstanding returns over a multi-year period. We have gotten close in some cases, but not yet in general. This has been a very difficult stock picking environment, and the rapid price moves have made trading very tough also.

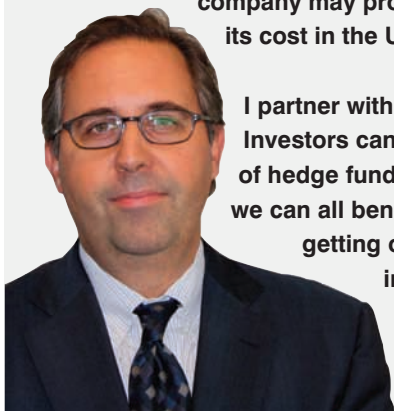
Phil Blazek

I agree that Europe is very difficult to analyze, but I think in general it points to the fact that we are in a lower growth environment.

At our firm we try to do what the Texas Rangers do (when they win): we try to swing at only the good pitches instead of every pitch. In an environment like this, we have taken our book down to a certain degree, but we are also looking for coiled spring type growth companies that have fallen in value during the market downdraft. The world does not stop; there are many models that still work, especially on a pure play basis within the small or micro cap universe where you find business models delivering a product or service in a better, cheaper, and faster way than traditional business models. These companies are often part of the solution to other problems in the world. For example, a small SAAS company may provide the broadband and software infrastructure to a much larger firm wanting to reduce its cost in the United States by more efficiently organizing workflows.

I partner with the Trammell Crow Family office, which started to accept outside capital this year. Investors can now invest alongside the family office, which has conducted full due diligence on a set of hedge funds, private equity funds and other investment funds, and together with outside investors, we can all benefit from economies of scale. This is the time when investors should be getting in, not getting out. Our investors understand what we are about and what type of companies we invest in. We did very well coming out of 2008, and through this cycle our investors understand what our model is.

Phil Blazek



A word cloud of various investment strategies and asset classes is scattered across the top half of the image. The words are in different sizes and orientations, creating a dynamic background. The strategies include: Equity, Innovation, Global Macro, Equity Derivatives, Base & Precious Metals, Commodity, Energy, Trade Finance, Transportation, Relative Value, PIPEs, Merger Arbitrage, Entertainment Investing, Real Estate, Behavioural Finance, Funds of Funds, Collectibles, Statistical Arbitrage, Infrastructure, Credit, Agriculture, SRI, Insurance, Long Bias, Structured Finance, Long/Short, Volatility Trading, CTAs, Fixed Income, Forex, and Event-Driven.

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Jerry Swank: If you happen to have a large, stable family office investor base that has been behind you for a long time, that is a very envious position as most other investors are busy worrying about what happened in the last two months, and do not look at what is really happening.... A lot of investors in our industry cannot take a look at long-term. We see them going completely the opposite to being very short-term focused.

So, also we have done what other people said. You have to shrink the book, you have to shrink the balance both ways long and short. We are long biased firm, so we have to be long our comfort level is between 60% and 80%. We monitor our risk management systems and have regular meetings. However, we used to talk about risk management and our risk systems once a week, while right now we talk about them once an hour, because you have to try to handle this volatility.

Jerry Swank



Another thing we have done is that we are “very actively not doing anything”, because it is very hard to do anything. Anyone that can trade this market on a daily basis is the smartest person in the world. Things have become that crazy. Therefore, we think you just have to take an outright and open approach like “here is our portfolio, we have upgraded the stocks we like, we have taken the volatility down, and we are going to live with it, and if you guys are not with us, I guess, you just would not be with us”.... That is the only way we can handle it.

Kris Kristynik: In your case Jerry, you know who you are - you are a long-biased MLP investor, and your investors and everybody else should know that. You have a clear mandate. But statistics show that the vast majority of hedge fund managers are increasingly positively correlated to the S&P500, admittedly or not. I believe that number will continue to go up, because everything is becoming more correlated: credit, commodities, and macro strategies are all significantly more correlated.

We view the increased positive correlation as a systemic risk, and therefore our protection-based products accomplish two things:

- 1) Offering a short-biased portfolio gives investors the benefit of our stock picking research while directionally placing their exposures on the side of the boat that is significantly less crowded and
- 2) Dedicated short exposure offers investors the opportunity to create portfolios where they could actually own a long-biased investment like Jerry's to create a balanced portfolio overall.

If managers like Jerry and Longhorn actually pick good securities, then investors can really focus on picking the best managers and create portfolios with a longer-term view.

Kris Kristynik



Matthias Knab

It is definitely one of the problems that investors have right now. On a stand alone basis, hedge funds do not hedge anymore. The challenge is as Kris explained to create meaningful portfolio structures that also include proven diversifiers and downside protectors like short-biased funds or CTAs.

Peter Neems

Having a large and diverse client base gives us a good idea what the different managers are doing at any given point in time.

Traditionally, hedge fund managers were hedging through currency forwards, pairs trading to set up market neutral hedges, and through some derivatives. Recently, we have been seeing a substantial increase in market derivatives and whole market hedges, i.e. volatility and variance swaps. We see both long and short bets on volatility. A lot of people right now are long on volatility because they assume the volatility will continue. They want to protect their investments from other market factors as much as possible.

In many cases we have seen these traditional hedges transition in investments strategies for funds. We have seen people make 'X' times Vega on their direct investments, not hedges. The main objective in this trading strategy is to play market volatility. It gives them a kind of holistic play on the global economy, including everything that is going on in Europe.

Peter Neems



Matthias Knab

If I look at the HFRI index results for September, all subindices except Short Bias, Regulation D, Systematic Diversified and Fixed Income-Asset Backed are down for the year. What is your view on that?

Jerry Swank

We had a difficult quarter, but in general one of the things that in my view does not make that much sense is looking at the last month of the last quarter, because sane relationships in the markets can become insane for a short period of time. I see this in stocks everyday. A company with good fundamentals can go down, while a company with bad fundamentals that was overly shorted, that is in a cyclical bucket or an ETF and maybe somewhat illiquid, then all of a sudden if the Russell 2000 is up, that stock can experience a sharp up-swing. In such volatile times, the markets can display many insane relationships. Over time they will level out, but in the short-term period they can stay insane.

Matthias Knab

Let's talk about Texas. How is Texas serving you as a base for your business? Why are you here? What is going on in Texas when it comes to hedge funds and investing?

Ken Sill

That is easy for me to answer, because most of the U.S. energy companies are based in Houston, to a lesser extent in Dallas, and now probably more of them are in Midland than 20 or 30 years back.



Ken Sill: When we were out fundraising, it was interesting to see that a lot of people who invest in our fund are energy people in one form or another. Almost anyone with money in Texas has been exposed to or involved in the energy business in some way - either you own mineral rights or someone in your family has worked in the energy business. These investors are very comfortable with what we do, because they understand the business and if they look at their own portfolio's volatility, they understand what we are up against and are actually fairly comfortable with it.

Texas has been a great place to raise money. Having worked for a Wall Street firm before, I think Texas is probably under-marketed by the New York and Connecticut folks. They live in and around the largest financial center in the world - there is

certainly a lot of money there, but not all of the money. Texas has a lot of money, and is a great place for business.

I also think Houston is a particularly open city and very accepting of people with new ideas. It is still a place where you can go out and pursue your dream, and if you do it well you can be very, very successful there. Houston is also a good place for the financial services industry, which is a sector that keeps growing in Texas. In fact, several former clients from my time on the sell-side have moved from Connecticut, New York, Chicago and other places to within a few blocks of this office. I believe they are quite happy being in Dallas.

Kris Kristynik

There are people who probably feel more comfortable doing business with folks in New York and Connecticut, and others probably like the idea of getting out of some of the group dynamic that can take place on the East Coast.

Texas benefits from having a developed hedge fund community between Dallas, Houston and Austin that can offer the potential for more diversity of thought in investors portfolios.

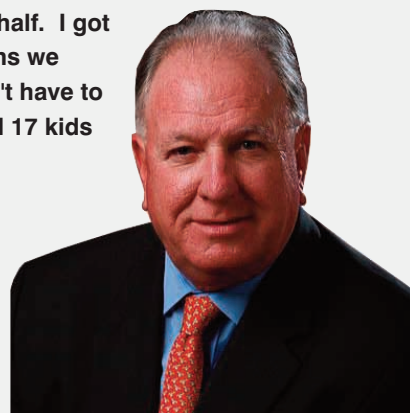
Jerry Swank

In fact, I had lived in Connecticut for five years before I moved back to Texas and opened my hedge fund here. Texas is first of all a very easy place to live, and from a hedge fund standpoint we had a lot more infrastructure than in some other places. We have the legal people, a lot of prime brokers and accounting firms, so you can easily set up and run a hedge fund or asset management business here.

One of our largest investors lives in Connecticut and their commute is an hour-and-a-half. I got 25 people in my shop and I bet the average commute for us is 11 minutes. That means we have a heck of a quality of life here that you cannot replicate at other places. You don't have to work till 8 o'clock, get home at 9:30 and never see your kids. We have 19 families and 17 kids in my shop, so that means a lot to our people.

Any business owner is always concerned to keep and retain good people, which is always a challenge. However, as we said living in Dallas or Houston is very easy, you can retain your people and without having state taxes, you can win the money discussion many times.

Jerry Swank



As Ken pointed out, the Texas connection does work well for people like us in the energy business. To a certain extent, I also believe people like being in Texas – you know and can talk about oil wells, fracking and pipes, and they like that. So, you have instant credibility over your competitors.

Being here also helps us launching new energy-related products, so it also spawns new business.

Ken Sill

People outside of Texas may not be aware that Houston became the center of the energy business in the United States by default during the 1980's crash in the oil business when everybody closed offices in Denver, Dallas, Tulsa, Oklahoma City, and Midland, and consolidated in Houston.

That means that most large integrated, and even international oil companies have offices there. You have people from Statoil, BHP Billiton, Petrobras, Shell, Exxon, BP and many more living and working in Houston. You get a pretty good feel for what is going on globally in the energy business just by living in a city where you run into these people all the time. If I lived in New York, I would probably not know these people. In Houston, my kids go to school with their kids, they play on sports teams together, I run into them at restaurants and charity functions. This is a great resource.

Phil Blazek

I grew up in a town just south of Dallas and I like it here; this is home for me. I lived in New York and Boston, San Francisco, and LA, so I feel like I have had a taste of other great cities out there.

Another benefit is that we are centrally located within the country, which makes it easier for me to cover companies on both coasts. And we take advantage of the fact that many company management teams make Dallas a stop on their road shows.

Dallas is a wonderful place to raise a family and from a business owner's perspective, I have talented people on my team and we are very pleased with our local service providers. There is no doubt that the hedge fund industry in Texas continues to experience significant growth and investors outside of the state are taking notice. Investors recognize that managers here may have a different perspective and can offer some diversification away from over-crowded names often circulating through other portfolios.

Phil Blazek



Matthias Knab

Jerry mentioned he is launching a new fund, anybody else working on a new product or a new idea, a new fund?

Peter Neems

We are seeing a lot of demand for what we call operational alpha. How can a manager create alpha in a fund, not just from his investment decisions but from the actual way he runs the fund? One way is by purchasing solutions that quickly and easily provide you with additional data and factors to include in your decision making process. Technology can help provide insight into market trends and data analysis that have previously been overlooked or too difficult to attain.



We have also seen a strong focus on managing operational costs and keeping focused on alpha generating activities. Many investment managers do not view their core business strengths to include hosting and running servers; it is rather something they have to do. We have seen a big push to outsource some of these functions so that clients can just pay a service provider to handle these ancillary business processes not core to their business. They can then maintain their primary focus and competitive advantage on investment decisions and managing their portfolio.

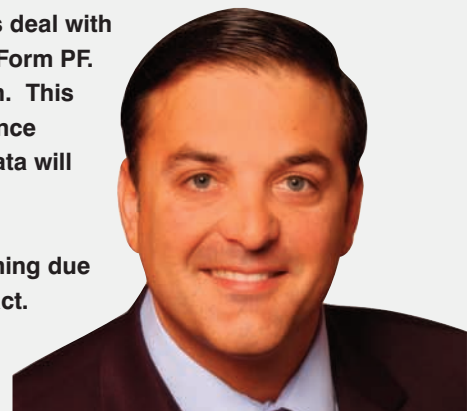
By providing that service, we believe people can focus more on operational alpha to be able to gain advantages from running their fund as opposed to being distracted by these other processes.

Peter Neems

Jorge de Cardenas: We are also launching additional services to help our clients deal with the previously mentioned regulatory and institutional demands. One example is Form PF. As an administrator we currently maintain the majority of the required information. This has been a high priority project for our business analysts and technology staff since April of this year. They are building the reports that aggregate and classify the data will ultimately populate the Form PF filing.

Another service area relates to requirements imposed by FATCA. KRFS is designing due diligence, reporting and withholding procedures to help clients comply with the act.

Jorge de Cardenas



As a result of the increased investor due diligence imposed on our clients, KRFS formalized a department in early 2010 which is 100% focused and responsible for addressing investor inquiries in a timely manner. This includes responding to due diligence questionnaires, scheduling and hosting on-site office visits and phone interviews. This is another example how the administration industry is exceeding the current and evolving industry challenges and helping its clients succeed.

Phil Blazek

We are speaking with some select investors about managed accounts that would be designed to take advantage of the attractive valuations currently in the micro cap space. These investors understand that it may take six months, a year or longer before our thesis plays out, but they take a long-term view and can accept the lack of near term liquidity for the potential upside.

Kris Kristynik: We have seen investors expressing keen interest in having customized short-biased managed accounts. Not all investors have a good understanding of short selling, so by providing more customization, potentially more liquidity and transparency, we can help investors get more comfortable with hedging options.



For investors, customized short-biased managed accounts are a new tactical approach to gain downside protection. And our portfolio and the stocks we look at are significantly liquid enough to manage fluidly so that we can quickly adjust to our view of changing risk reward or the risk appetite of the investor. We believe this is a very interesting option, particularly for larger institutions who want to buy protection, but in a potentially better structure than they could find elsewhere.

Kris Kristynik

Burke McDavid

I am curious to what extent managers factor in political or legislative risk – do you use consultants or do you make any effort yourself to analyze those issues at any depth?

Jerry Swank

You do not have expertise in everything, but on the other hand you have to be worried about the new compliance regulations related to this expert network issue.

You can use firms that provide political intelligence like STRATFOR, or lobbying agents, People can work on different issues in Washington. However, I don't know if I can find an expert that can help me to get more comfortable on the EU question. But sure, for some of these questions you need intelligence from the outside. There are so many things happening beyond your purview where you need to try finding the experts in order to give yourself an advantage. But again, this expert network issue scares me, in the end you don't control these people and while you are doing nothing wrong, these folks may be doing something with somebody else, and you have no idea about that.

Ken Sill: At a former firm, I looked at an expert network where you could sign up for conference calls with industry experts, or executives. The issue was always where do you cross the line between insider and non-insider information? Even if it was not insider information, you were never sure, so we decided to stay away from the expert networks and have done the same at TPH Asset Management. We do use research from broker-dealers, and at times speak to policy experts in Washington DC, because you have to cut through the rhetoric and find out what is really going on with the regulators and in Congress.



Ken Sill

For example, with the Macondo spill there was a lot of uncertainty surrounding the Bureau of Ocean Energy Management, Regulation and Enforcement, or BOEMRE. We had a tough time trying to figure out what the regulators were trying to accomplish, how much was being driven by the White House

versus Congress, etc. Obviously, on the coal side, increasing environmental regulation will have a large impact on the industry's structure in the coming years and many of the rules and their timing remain in flux.

The other elephant in the room that seems relevant to this question is China. What does China want, and what can China do? When I was at Credit Suisse, we visited China and talked to government officials, and industry experts. Most people in the West do not understand what motivates the Chinese government. Simply put, the Government's goal is to make sure there are enough jobs for people moving off the farms and into the cities, so that there is not another revolution. Revolutions tend to get very bloody in China. The Government has many levers they can pull to achieve their goals, and they have a lot of money in the bank.

I would be curious about your view on China – the Government's plan is to grow 7%-8% a year, but they have been growing 11%-13%. They want to slow down the growth, but is 7%-8% a sustainable growth model to forever? Probably not.

Kris Kristynik

I think there are probably more people trying to answer that question than any other at the moment...

At Longhorn, we looked at the math and saw what the Chinese banks did in terms of extending credit and the subsequent impact on the money supply. Chinese bank loan books have grown dramatically since 2008, with a large portion of the financing going into fixed asset investments. Fixed asset investment has been the key driver of GDP growth over the last few years, and as the marginal return on that incremental fixed asset investment goes down or goes negative, you eventually end up with a ton of bad investments.

That means there are many bad credits in China while there is still lot of fiat money floating around, supporting inflation. To your point about growth, they are definitely concerned about growth and employment, but I think the extent of the policy response was so great in 2008 and 2009, that it created an environment that will generate much lower growth going forward. Much like the developed world, they have merely brought years of future growth forward in order to prevent needed corrections. While that approach makes current growth and earnings statistics appear robust, the negative ramifications of policy excess remain to be dealt with.

From our point of view, we find it very difficult to think the Chinese can get out of the current situation without a real dislocation happening. However, most investors remain sanguine about their growth prospects. Timing these things is very difficult, but we suspect at some point, the China growth story will end badly.

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