

Hedge Fund Roundtable

Given the tumultuous market environment that hedge funds faced in 2008, Stratford convened a hedge fund of funds roundtable to discuss issues they encountered in 2008 and how the landscape for investment and regulation may change in 2009. Senior investment professionals from four prominent hedge fund of funds firms participated. Stratford's CIO and Director of Manager Research, Susan McDermott moderated.

Moderator: Welcome. Thank you all for participating. Given everything that is happening in the marketplace today, Stratford thought it would be a good time to review investment processes at hedge fund of funds firms. Can you comment on how your investment process and operational manager due diligence changed as a result of what happened this past year?

Manager A: We have always had a defined investment and operational due diligence procedure that has centered on a lot of in-person due diligence by the senior investment professionals of our firm. For our core positions, we conduct three to four visits a year; for our largest exposure, four to six. Everyone else in the portfolio, at least one to two visits, regardless of length of relationship, allocation size, or complexity of the business.

We also have a distinct operational due diligence process, with the head of operational due diligence visiting every underlying manager in the portfolio at least annually, as well as visiting prospective new allocations prior to making the investment.

So I wouldn't say that we have in any way materially changed things. We've certainly seen certain knee-jerk reactions to perhaps some investors having realized some unpleasant things with respect to Madoff exposure, but I think as we look across our managers, and the demands we have always made, in terms of top-quality service providers. Big Four auditor or hedge fund specialists, third party custodians, and quality infrastructure of the underlying manager, I think our processes were vindicated by avoiding a lot of the landmines people found in 2008. But I would not point to any significant change, only the fact that we're pleased that our senior professionals have been visiting firms very frequently on both an investment and operational perspective.

Manager B: I would agree with Manager A. We have the same hands-on approach, which is why we want our senior people out on the road visiting with managers—it's the best way to get the primary information from our managers and obtain the best understanding in making our portfolio decisions.

As regards Madoff, it's clear that the process worked for nearly everyone. In my mind, no credible hedge fund investor would have been invested with Bernie Madoff. If you had just scratched the surface in terms of exercising proper due diligence, you would have run, not walked, away from the situation, and I think most people did.

The funny thing about Madoff is that he was so controversial within our industry—as an investor, you had to know that you were taking reputational risk by making an investment. The potential was always there for something unsavory to be uncovered, whether it was front running or doing something else. Why bother risking your reputation? There are plenty of other fish in the sea. The near-term effect of Madoff is going to be investors asking, "What is your due diligence process and how would you uncover something like this in the future?" Once they understand how all of us conduct our due diligence, they are going to be more comforted, and I think the fund of funds model, going forward, will be strengthened, not weakened, by the Madoff event. Also, the notion that investors should go direct to hedge funds in order to save on fees will be back-burnered—avoiding mistakes like Madoff or other similar situations is a critical element in the value proposition for fund of funds.

Manager C:

I agree that the operational due diligence we all do was validated in 2008. There are some things that all firms will probably do as a result of 2008, not just because of Madoff, but for other reasons as well—these include enhancing their operational monitoring of managers, looking at FASB 157 issues further, looking at counterparty exposure and counterparty risk in greater detail, and focusing on settlement and liquidity issues. So, those are areas of focus probably for all of us—not new steps of due diligence, just heightening existing processes.

Manager A:

And I think all of us are really looking to tailor operational due diligence to be proactive as far as spotting issues, rather than reactive. Maybe looking at things like counterparty risk, before Bear Stearns goes down, and subsequently before Lehman Brothers goes down, to start saying, “What do your prime brokerage relationships look like?” Also, getting a sense of, “We all know when FAS 157 is going into effect, what are you doing to prepare for that?” And so it's starting to look at valuation, at counterparties, at financing, before things actually become an issue.

Manager B:

Nowadays, how many times have we asked: “Where do you keep your cash?” How relevant was that before Lehman went under? Not terribly. After Lehman, where a fund manager keeps his cash has become a really important thing.

Manager D:

I agree with what everybody said. Speaking for us, what we do has not changed, the topics we try to cover, the procedures that we have, in terms of looking at the variety of operational due diligence issues from valuation, to checks and balances, and controls.

The one thing that has changed is scrutiny over the contract between the LP and GP and ensuring that the manager abides by the “letter of the law”. And I think there's been more scrutiny over what's not said. There are a lot of operational issues that connect to the contract between the GP and LP. I'd say that's the single area where if you were to ask our operational due diligence team, “Where has your workload exploded over the last six months?” it's probably in everything connected to contract and assurances around that contract, related to liquidity, related to procedures, related to satisfaction of gates, etc. and monitoring behavior with respect to what's said and what's unsaid.

Moderator:

I think that's a good segue into the issue of redemptions and gates that many hedge fund managers have put into place. How are each of your firms managing liquidity?

Manager D:

We are maintaining more cash. The way we've always thought about liquidity is in the form of a budget: we have liquidity that we offer our investors and we have liquidity that our portfolio has by virtue of the terms of the agreement. Now, some of that liquidity has proven to be illusory in nature. But we think about it in terms of having a budget and as we extend beyond, quarterly liquidity that's real, or that you think is real, you've got to be careful about using that budget. It changes how you think about risk/return in extending liquidity and so forth.

So, certainly we've scrutinized as heavily as ever the usage of that budget, and we've spent a lot more time than we did a year ago, setting our expectations for the stated liquidity versus the real liquidity because of what's happened. But ultimately, as you get through all that, we still think about it in the form of a liquidity budget, it's just the effort that we have to go through in scrutinizing the budget and the reality of what's there has taken a lot more time and effort.

So, the construct hasn't changed; I think the effort in evaluating it has changed.

Manager A:

With respect to handicapping liquidity, I think that's a correct way to think about it. As I've listened to a lot of the press coverage of the fourth quarter 2008 and discussion of quote, "the broken promises of hedge funds," there seems to be this implication that hedge funds in general changed the rules in the middle of the game. I certainly think that there are isolated incidents of hedge funds that perhaps behaved irresponsibly or poorly. On the other hand, I think that if a hedge fund offers certain liquidity and says, "We have quarterly liquidity with a 10% gate," it is up to the investor to handicap the probability that the manager gets north of 10% in redemptions, and if they do, I don't have a problem with them imposing that gate, given that the gate is what allows them to offer that liquidity, paired against the liquidity of the portfolios they're managing. And you know, if it's quarterly liquidity, with the option of a gate at 10%, I don't think that you can—if the manager gets 15% or 20% redemptions, scream and say, "You've changed the rules in the middle of the game." It is the job of the fund of hedge funds, or of any direct hedge fund investor to say, "What do I think the probability is that this manager will receive that level of redemptions?"

I also think that there are other firms that suspended redemptions; there are two that are in our portfolio, and I look at the terms that are very clearly stated in their documents, if there is a massive market dislocation/event, "We reserve the right to suspend." It's not a rule change in the middle the game. I do think you need to appropriately handicap what those odds are, and as a fund of funds, invest appropriately.

Manager B:

The markets have just gone through World War III, and some managers are taking a number of steps to preserve value for all shareholders. All of us understand what managers can and should do, but I think that it's the social contract you're talking about versus the actual, legal contract. What is meaningful is how people respond to the environment that we've just gone through. There are a lot of managers who have the contractual ability to suspend redemptions, gate, create liquidating share classes, etc. All else being equal, they would choose not to implement these burdens, because they want to preserve their reputation, track record, business value and things like that. The managers you really want in your portfolio are those that are going to act responsibly, regardless of their contractual rights.

Manager A:

But at the same token, I assume that you have provisions in your documents, should everyone asked for their capital at the same time that will allow you to behave responsibly.

Manager B:

Absolutely. But we will do everything we can to avoid that, because that is a reputation jeopardizer, and effectively you're just saying "I expect to go out of business."

Manager C:

I agree with Manager B about understanding when managers invoke these provisions and I would actually make an even stronger statement that in many cases, we support the action.

One of the most compelling attributes of hedge fund investing is that the managers have their own money invested alongside our investors, and I think it's safe to say that in 100% of the cases for top quality firms, that's true. And in any instance where a manager is gating, suspending, side pocketing, et cetera, they're not just protecting our money, they're protecting their own money, and that's a very important kind of moral contract.

Now, there are cases where it is not as appropriate, and in those cases, we obviously are not pleased and push back, but there are plenty of cases where managers simply don't have the liquidity that they thought they had, and we support taking certain actions in those situations. That's the reality of the current environment.

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Moderator: Do you see many changes in the terms of the documents for the underlying hedge fund managers or do you think they've done a good job making sure their terms can deal with very stressful environments?

Manager A: I think by and large, they've done a pretty good job. I think the largest shift you will see is perhaps a greater level of awareness by hedge fund investors that offer quarterly liquidity.

Manager B: I think we'll see managers evolve their fee structures. One change that makes a lot of sense is aligning incentive fee recognition with liquidity terms. For example, if a manager has a two-year initial lock-up, there should be a crystallization of the incentive fee only after that initial two-year period. This asymmetry of fee recognition was not an issue prior to 2008. In 2008, it became a huge issue because most hedge funds did really well in 2007 and then got crushed in 2008, leaving their investors with a bad taste in their mouths—paying big incentive fees in the first year without any ability to redeem capital or otherwise adjust their exposures to the managers. So, I think that there will be—and should be—more alignment in that regard.

Manager C: Generally speaking, the pendulum has swung in our favor. The top 2% or 3% of managers may be on the stronger side of the supply-demand spectrum in fee terms, but with most managers, I think that the pendulum has swung and you will see more investor-friendly terms, such as deferral of incentive fees until realization or the end of the lock-up period, and perhaps lower fees and hurdle rates. I also think you'll see more anniversary date liquidity or other types of ways to stagger liquidity, so not everybody can exit at the same time. And there might be fewer managers with monthly and quarterly liquidity. That may be viewed as a negative by some, but not by others.

Manager B: I think it's a positive.

Manager C: I think it's a positive, too, but it would probably be viewed by the newspapers as a negative.

Manager B: Sure.

Manager C: But mostly, I think, the paradigm shifts will be positive.

Manager D: I agree with Manager C, in that clearly the contract and the terms, especially as it relates to liquidity, were out of balance in the industry and beyond just liquidity. It's not because investors were uninterested or didn't understand that they might not be perfectly equitable or as equitable as they could be. Supply and demand in the industry was unbalanced in our business for a long, long time. And progressively over the last few years, the contracts became more and more tilted towards the GP and away from the LP in a very fundamental way. And I'm sure all of us worked hard to negotiate appropriate terms, but it was difficult in an environment where the demand for capacity exceeded supply. That's changed, and I think there will be, as Manager B said, a natural migration. I think there's a whole assortment of things that need to be "re-legislated" in the standard terms between allocator and GP.

**Manager D:
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We could talk about dozens and dozens of things that could stand to be improved dramatically, and balancing the relationship between the GP and the LP, but ultimately I think the single biggest sort of structural/economic flaw between GP and LP is the lack of some sort of clawback provision as standard in the business, because it creates a fundamentally inequitable incentive system between GP and LP. There's this "heads I win, tails you lose" dynamic that's difficult to get around. When you talked about the two-year lock, it's essentially the same thing, right? It's putting a longer horizon on the realization of fees.

So that's the single-biggest issue where there's a fundamental flaw. It's going to be interesting to see whether or not both in spirit and mechanically that can be resolved. There are all sorts of related issues to be considered so it doesn't create another perverse incentive.

Manager A:

What's interesting is that this is not unique to the hedge fund industry. Obviously, people are looking at the investment banks and at senior executives that were paid tens of millions of dollars or hundreds of millions of dollars over the years preceding 2008 and then presided over this absolute collapse that destroyed so much shareholder value. People begin to wonder: "Well, what about that compensation in prior years?"

So, if I thought fees could change in the hedge fund business in any way, I would see the idea of the clawback or the multiyear compensation arrangement, because there is something troubling about getting paid an incentive fee on, in many cases, unrealized gains and then watching those dissipate over the course of a year like last year. That's the fundamental idea of the majority of hedge fund compensation. Being performance or carry-based is justified in a year like 2008 in that underlying managers lost a lot of money over the course of 2008, and they won't get paid in 2009 until investors are whole.

I think that, as we look at our portfolio, you obviously need to satisfy yourself in terms of the structural integrity of some of these businesses. At the smaller end of the hedge fund business, in the sub-billion shops that are below a high-water mark and are looking for the carry to pay top people to keep their doors open, you have some structural issues. But, at least in our portfolio, where the average manager is north of \$9 billion in assets under management, you are looking at a level of management fees that can sustain those businesses and at a pretty cheap fee structure in a year like 2009 as people are, in theory, recovering from the dislocation.

Manager B:

I think one of the interesting things about 2008 is the uniformity of terrible results. Most everybody is going to be very determined to earn back their high water marks. I don't think there is an opportunity for people to say, Okay, I'm going to close and then reopen down the road to reset the high water mark.

Moderator:

That's gone? That's an old game?

Manager B:

That was an old game or, at least, it's a game that's not going to be played by 2008 managers. Everybody's pretty upset. They're going to do the right thing for their investors.

Manager C:

Moreover, high quality managers are generally open today for additional capital. So, if somebody was going to do that, they would not have an easy time raising capital, both because it would be viewed as unethical and because high quality healthy managers, for the most part, are open.

Manager B: Right. Exactly. That's a great thing for us.

Manager A: If you look at the top quality managers out there, I think that people are embarrassed by performance in the last four months of 2008 and really are at a point where it is a matter of personal pride to get it back, not— “Oh, how can I close down and start generating incentive fees again”. These people made a lot of money in the five-year period preceding 2008 or, in many cases, much farther back. And I think it's less about “When do I get paid again?” than “When do I get my investors in a place where they should be again?”

Manager C: I agree with that.

Manager B: Also, their staff isn't going to leave because, frankly, where are they going to go?

Moderator: **Talking about performance, I know that in speaking to our clients, they've generally been very disappointed with hedge fund performance. And I think, in some ways, it was the way it was positioned as an uncorrelated asset class, good downside risk, a positive return when the equity markets are down and it will outperform bonds. What's the incentive for the institutional investor to actually stay in hedge funds? Do you think it should be positioned differently, particularly for hedge fund of funds, than it may have been in the past?**

Manager C: First of all, I don't think that we ever positioned it as uncorrelated, so I have an issue with that word. I think that lesser correlated is the way that we positioned it. And I think that '08 is probably not the best environment in which to judge correlation. But, overall, I think the reason to stay in hedge funds is fairly straightforward. First of all, from a performance standpoint, over virtually all reasonable measurement periods, long and short periods, including '07 and '08 and '09 thus far, hedge funds as an asset class have outperformed pretty much every other risk asset class, other than perhaps government bonds. In January of '09, for example, we're probably all up 100-plus basis points and the S&P is down 8.5%.

Secondly, I think, to take capital out of a hedged approach today, where the only real quality short exposure that investors can get is from our approach, makes no sense. It's a horribly uncertain world. We're offering real hedged exposure. And to go long only today doesn't make sense. To go to cash today doesn't make sense for any institution with a long-term time horizon and an actuarial hurdle. Moreover, distressed investing is really where a lot of our managers are experts. Today and going forward you're going to have a lot of very good distressed opportunities. So we're telling our clients, and not just saying it, we believe it in our hearts—now is the time to add capital to our space as opposed to take it away. We put our own money in that.

Manager B: I couldn't agree more with what Manager C said. This is going to be a huge investment opportunity for the next five years, not only distressed but also in long-short equities, because last year was all about beta. The intra-stock correlation was at a 21-year high last year due to the unparalleled need for liquidity. This year, with the economy going into recession globally, there's going to be a lot of differentiation on the part of investors between good and bad companies—the fundamentals will matter again, and intra-stock correlation is going to come down, meaning that we're going to see a huge wealth of opportunities in equities, long and short. On the short side, this is the only source for people to have any kind of hedged exposure. I agree with Manager C on that point.

Manager B:
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The opportunities in distressed are huge and are not going to rely on capital flows for realization of value because we're going to go through a lot of restructurings, reorganizations, bankruptcies, where value will be realized, regardless of how much money people put into the situation. And, it's not going to be a V-shaped recovery like we've seen in the past, in 1998 or 2002. But over the next five years, the compounded rate of return from hedge funds is going to be enormous.

Getting back to your point about how fund of funds were presented to investors in terms of performance and risk: anybody examining hedge fund returns will see that we have had periods of great stress in the markets—look at 1994, look at 1998—those were periods when things went haywire. We had the flight to quality, the de-risking, and the de-leveraging. It's abrupt and generally unfolds at breath-taking speed. The stock market event is caused by the same externality as the hedge fund event. It's not the market going down that causes our returns to go down. It's this exogenous event, whether it's the unwind of levered carried trades (1994), the Russian pandemic (1998) or a flurry of corporate malfeasance scandals (2002) that create the flight to quality and causes risk-based assets to suffer. Once the markets get through that period, the dislocations have created enormous opportunities.

Manager A:

I see many articles that say “hedge funds, which promised to deliver positive returns in all market conditions” and you sort of look back and you say no, that is not what hedge funds ever promised. What we have said over our history is that we attempt to remain as uncorrelated as possible to equities and fixed-income. We have generated positive returns in positive equity markets and in negative equity markets. Our vulnerability does tend to be to the, as Manager B says, systemic events or the shocks to the financial system. You saw it in the fall of 1998. You saw it in the summer of 2002 and, obviously, at a much greater magnitude as you had the failure of Lehman and subsequent bailout of AIG and Morgan Stanley and Goldman Sachs hanging there in the balance in that one week as you began to have concerns about the viability of the financial system as a whole. The credit markets froze. The equity market went into freefall. And, certainly, managers in our portfolio took losses as well.

I think it's unreasonable to think that these asset classes won't correlate during periods of extreme stress.

Manager B:

When we talk with investors about the downside, the risks—I can guarantee that we have all said the same thing: when things go haywire, we're going to suffer. Period. We are going to do everything in our power to protect our portfolios, of course, but it's going to happen, and it's going to happen episodically.

However, if you look at the period from 2000 to 2002 when stocks suffered huge declines, it was a golden period for all of us. We had fantastic returns in the midst of a very fundamental, mostly orderly, equity-specific decline in the markets, which was tied to overvaluation in the technology sector.

Manager D:

As Manager B pointed out, dispersion or, intra-security volatility was actually quite low over the course of the year. So now you've got an environment where there's been tremendous dislocation. But, if you believe that you can find hedge funds that are skilled in selecting securities across asset classes, across styles, and so forth, the ability to do so now is extremely high relative to what it was a year or two or three years ago.

The environment is still very tricky, and we could spend three hours talking about all the reasons why. But thinking about the relative risk/reward of betting on skill versus betting on market, it's a great trade right now.

Manager C:

It's not just a talking point. You can see the attractiveness in the risk/reward profile by looking at the leverage numbers. Leverage is down so much today that the asymmetry, downside versus upside, is better than it has been in a long time.

Moderator:

So there are really compelling opportunities, and no need for leverage to generate strong returns.

Manager B:

Well, right now the cost of capital is very high. And so that puts expected rates of return on unleveraged situations at a pretty attractive point. You don't need leverage to make great rates of return.

Over time, the infrastructure will calm down. The banks and investment banks—the leverage providers—will return. Being a prime broker is a good business. And things will return to a more normal state. I think we'll all be better—I like to quote Nietzsche, “What doesn't kill us makes us stronger.” The folks who survived 2008 and learned lessons from 2008 will go forward much better prepared to deal with liquidity issues and how to structure portfolios. We're all going to be better. So I'm very excited about the future.

Moderator:

Are you changing benchmarks at all? T-Bills plus 3% to 5% is common. What are you using in your reports today?

Manager A:

At least at our level, I would not move away from that benchmark. I would say that it is applicable in any 36-month window, which I think takes into account the fact that you are going to have systemic shocks. We have always said - The question is not will we have another systemic shock as it is when? What will it be? What will the magnitude be?

When the world goes haywire, we will typically underperform. As you look at the types of strategies in which we are investing and, just as importantly, at the kind of managers in which we're investing that have actually structured themselves appropriately, that have proper financing in place, that are not forcing dollars into an environment where there's essentially no bids, you do see an ability to outperform coming out of the dislocation.

So I would expect to underperform during systemic events and outperform in the periods coming out of those systemic events. Certainly if we look back at fall '98 and what our returns looked like in November of '98 and into 1999. The same thing in summer of '02 where we saw suffered a draw down and what our returns looked like in November/December of '02 and into '03 as credit traded back to more rational levels.

I do think that there will be short-term volatility over the course of '09 and 2010. I think everyone is looking at a compelling opportunity set over the next 12 to 24 months.

Manager C:

There's a lot of yield available today in the credit books. I mean you're senior in the capital structure—getting nice, current, positive carry. You don't really have to make a bet on a recovery in order to earn returns in this environment, or, at least, over time. None of us are predicting when things are going to turn around. But I don't believe that, collectively, our managers are betting on a recovery. They're really setting themselves up for good, positive carry while they wait and to really capitalize when things do start to stabilize.

Manager D:

The original question was about benchmarks. We don't really have a magic, single benchmark. We think about it in a few different ways. One way we think about it is sort of a risk-free rate, plus premium approach, through a cycle and with some expected level of correlation—low, it's not zero; nor is it actually negative. I think some people had the false expectation that hedge funds were inversely correlated. This idea of a risk-free rate plus a premium over a cycle is one way we think about measuring ourselves.

Another way we think about measuring ourselves is relative performance to traditional asset class benchmarks. We tend not to use only equity asset class benchmarks because, the reality is, there is a big footprint of our portfolio that's in credit related assets. We tend to think of a hybrid of global equity and credit assets and how we're doing relative to that on a risk-adjusted basis.

And then the third way we think about it is as a representation of skill. Internally, the measure that we hold ourselves most accountable for is trying to understand the portion of our return that comes from market factor beta and from skill. With respect to skill, we do a tremendous amount of analysis to try to isolate and understand the sources of skill.

So there is no one answer. We try to use a hybrid of all three of those approaches.

Moderator:

You know us consultants, we like to benchmark everything.

Manager B:

Interestingly, there are many reasons why people leave the so-called “traditional” investment world to go to hedge funds. One is that they want to move away from the burdens of benchmarking. Hedge fund managers want the freedom and the flexibility to manage an investment portfolio to generate absolute returns. So, in a sense, zero is the benchmark over an investing cycle. But what should you deliver over a three- to five-year cycle? We use double-digit rates of return as our benchmark over that three- to five-year cycle.

Moderator:

I think we talked a little bit, going back in the conversation, about some of the good things that are going to come out of this market environment. It sounds like one of the areas that potentially might be a negative is increased regulation for hedge funds. The press seems to be pushing for increased regulation. Perhaps the government is pushing for it as well. Do you see that actually happening? And do you view it as a positive or a negative?

Manager C:

I think that today's government announcement that it may limit executive pay to \$500,000 for all financial institutions that received TARP money might not achieve its desired goal. These institutions might lose talent, or the institutions might try to raise equity to pay back the TARP money, thus not achieving TARP's goals. Sometimes these regulatory things can have unintended consequences.

But I think there are positives and negatives. I don't think we necessarily look at more regulation as a negative. One of the positives is that it may result in more credibility in our industry. Additional regulation could also eliminate some of the lower-quality managers who don't have the ability to pay for the infrastructure requirements that regulation brings. And it could possibly, over time, reduce problems like fraud and misrepresentation. So I think there are positives.

The negative would clearly be anything that potentially reduces the competitive advantage of managers, such as, for example, limiting their ability to use short selling, credit default swaps, or requiring increased disclosure of their positions. We don't welcome those things. We don't think those are good for anybody. I think the government has already acknowledged, in fact, that the short-selling ban was a mistake. And it's not coming back.

Manager B: Never say never.

Manager C: Never say never. In fact, there are some Asian countries where it still hasn't been lifted. But, overall, I think the type of regulation is more relevant than the quantity.

Manager A: I agree with you, Manager C. In a lot of ways, I think that regulation could help in certain ways to repair the public trust, given that the hedge fund industry is always one that's seen as not particularly transparent, one that previously resisted regulation. The press coverage generally is negative toward the industry as a whole. The idea of actually having government regulation seems like, at least, a positive to us. I agree that it will likely be a compliance burden for the smallest firms out there.

The other side of the coin, though, is that people's level of faith or trust in government regulation has been severely diminished in that the government needs to repair its trust with the public in terms of an idea that they actually know what they're doing, given that they were in Madoff's office multiple times and missed the thing entirely and ignored a huge number of warnings. So, in our view, I think that the government needs to prove to the public that regulation actually means something. We have always pointed out to potential investors that our firm has been a registered investment advisor with the SEC since 1999 and that the SEC periodically does come in and audit us. And their last visit was summer of 2007. And saying that to people after Madoff, they sort of laugh and say, well, so what? What does that mean?

Manager B: And, clearly, there needs to be consolidation among the regulatory authorities not only here in the U.S. but globally as well. It would be great to have a principles-based, regulatory regime implemented in the capital markets because it is a global business. We would welcome that.

Moderator: **It's been kind of interesting to live through 2008 and see all the negative publicity on hedge funds. And I think, to some extent, some of the public reaction in that the public—and actually, even other money managers are just angry that hedge funds were quicker on the trigger to delever and get out of positions. Do you see that as being some of the issue or just a misunderstanding of the whole industry?**

Manager C: Well, I think that there is and has been a lot of jealousy and animosity over the pay of highly publicized managers and the hedge fund fee structure in general. I think it's newsworthy. We've had managers that have had poor results over time that hardly ever make the paper because they're good, honest people whose strategy simply didn't work. But then you see these tiny little firms that are irrelevant and that nobody has ever even heard of who committed fraud or other bad behavior and they are on the front page of the newspaper.

Manager B: Absolutely. PR is something that we should be better at, but collectively, I think we're all afraid of it. I think that we all do a fantastic job of being good stewards of our investors' capital, but that really hasn't been the message, and we need to get the word out.

Manager A: Every hedge fund article refers to secretive, lightly regulated pools of capital for the rich. And that's the way hedge funds are covered in the press. And that's the first line of every article.

Manager B: We are managing money for the everyday guy on the street who participates in his company's pension fund. Most of our capital comes from institutional investors.

Moderator: I think that's very misunderstood.

Manager D: And I just think something very fundamental is mis-portrayed regarding hedge funds because of the “news sexiness” thing, and that is just the fundamental risk/return profile of hedge funds. They're portrayed largely as being gun-slinging operations. It's funny and I'm sure everybody in the room can attest to this same phenomenon. Whenever I have a conversation with a friend or a family member about what we do—someone who's not in the investment business and has got a moderate understanding of investing generally or maybe reads the business section of the *Tribune* or reads the *Wall Street Journal* from time to time—and explain the very fundamental notion, which is that I spend my time trying to build a portfolio that delivers a potentially moderate return, with a low-risk profile, they're dumbfounded by that very basic proposition. This is because the press has conditioned people to believe that hedge funds generally are sort of casino ventures. Certainly there are high-risk return ventures, but the reality is that there's a lot more risk in any given risky asset relative to most hedge funds and, certainly relative to, a composite of multiple hedge funds. I don't know how or why it's happened, but I think it's just a very fundamental misperception.

Manager A: Characterizing hedge funds as sort of an asset class broadly seems to be inherently a mistake, given the number of different approaches in risk/reward profiles.

Moderator: Would you mind summarizing what you think of 2008? It was certainly a career experience I think none of us will ever forget. And, what you think 2009 will bring?

Manager C: Well, I think that, as painful as 2008 was, it may be that we all look back on it and think that the asset price decline was a necessary event in the long-term history—or the long-term efficacy of our global financial system. There was too much leverage. There was too much risk taking and that it was a corrective year and these things are necessary over long market cycles. At least I'm hoping that that's how we'll look back on it because it sure was painful. But I also think that, if you look at hedge funds, that the losses that we experienced in '08, while painful, are acceptable in the overall scheme of things. And if you look at our long-term returns, they've been very solid. And furthermore, if you look at the fact that we're alive today to take advantage of these opportunities, it's very, very positive. The competition for high-quality investments is much lower. The buy-side of banks is essentially gone—the investment banks' proprietary trading desks are essentially gone or significantly reduced. Lesser-quality hedge funds are or will be gone. Mutual funds are in net redemption mode. You really have probably less than half of the demand for risk investments that you previously had. And the supply is very big.

So, I think from a forward-looking standpoint, that healthy managers, although not loading up the truck—as everyone is generally cautious—are able to play a bit of offense and they have the cash today to do so, which is a favorable position. We've all made some mistakes, and we've terminated those managers. But the managers remaining in all of our portfolios, I'm certain, are where we believe investors should be.

Manager D:

I think cyclically it's a great time for a lot of the reasons we outlined. Market dislocation, risk premiums, opportunity to pursue potentially attractive risk/reward. More secularly, I think the last year, as painful as it was, will in fact be good medicine for our space in particular, because it will recalibrate supply/demand. I think the nature of doing business will be equalized across the space in a way that's good and fair for everybody.

So the result of all that is a really good environment to both invest and do business. And so I'm very optimistic.

Manager B:

I agree with all of my colleagues in that regard. I think we all have that same expectation. We know what the story is going to be. The survivors will do extremely well. As this industry moves forward, investor confidence will return to these investment strategies, and it is my hope that hedge funds will no longer be called hedge funds, but rather absolute return funds. I believe that absolute return investing will be entirely mainstream in the next five to ten years, and comprise the primary component of investors' portfolios. Institutional investors, in particular, will embrace absolute return investing because they have to put money to work to generate their actuarial returns.

Manager A:

In our view, 2008, particularly the last four months, were an exceptionally frustrating and disappointing period. When you invest in strategies that are based on rational pricing relationships, and then you see rational pricing go out the window in the midst of this horrific, systemic event. It is very hard to live through.

And I would also point to the cyclical nature of things and the fact that, coming out of these periods of dislocation, these strategies do tend to outperform. We are very optimistic about 2009 and really optimistic about pricing returning to a more rational basis than about some form of economic recovery. Take a month like January, where most hedge fund managers are still generally bearish about the economy yet are able to generate positive results during a period when the S&P is down roughly 9%. You do see the potential for positive returns even during an environment where the economy may continue to degrade or break down and the equity markets either trade down or sideways.

Moderator:

We should end on an optimistic note. Thank you.

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