# FOCU$

Newsletter of Horizon Cash Management LLC • Fall 2009

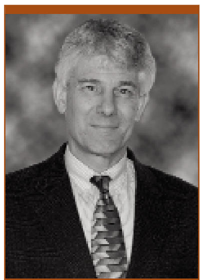
"What's Next?" is the theme of this issue of *FOCUS*. Inside, you'll discover what lessons five industry experts – representing firms as diverse as a hedge fund management company, a family office, a managed futures platform and an investment consultant to pensions, endowments and foundations – learned from the recent global financial crisis and how they skillfully addressed those challenges. Pauline Modjeski notes how the lessons of the past sometimes get forgotten too easily. And we introduce you to three books that provide a fascinating 'behind-the-scenes' look at how last year's near-implosion of the U.S. financial system was narrowly averted.

## What's Inside



*In this issue of FOCUS, five senior executives within the alternative investments industry – each representing a different market segment – share what they and their firms learned during the past year's economic crisis, how they responded to those market challenges and what significant events they see on the near-term horizon. While the backgrounds and experiences of these contributors are richly diverse, the economic themes and business trends observed by each tend to mirror and amplify those identified by the others. We think you'll find these viewpoints interesting and enlightening.*

# "Hurricanes and Tsunamis":
## An Interview with Ernest Jaffarian


Ernest Jaffarian

**Ernest Jaffarian:** My name is Ernest Jaffarian. I am the founder of Efficient Capital Management. We were founded in 1999. I am currently the President and CEO of Efficient, which is a specialist in the multi-manager CTA space. We run multi-manager portfolios for institutions, large family offices, high net worth individuals and so on.

**FOCUS:** *Welcome. Let's begin by having you tell us how the last 18-24 months – as tumultuous a period as any in recent economic history – have played out for you and your colleagues at Efficient.*

**EJ:** The past 18-24 months have been among the best periods in the history of our firm. To put this into perspective, it's important that one thinks about what sources of income exist within the trading community. I find it interesting that the research firm, Ibbotson Associates, published a paper in 2006 that essentially said that managed futures should be a significant percentage of any well-diversified financial portfolio. What that paper prophesied came to be in 2008. The question that I'm most commonly asked is: "how is it that Efficient's portfolio did so well in a year when traditional assets – and almost all hedge fund strategies – had such difficulty?" I think the answer has to do directly with evaluating the sources of return. It was EDHEC, the research firm out of Europe, that published a paper that suggested, in addition to traditional data returns – such as the return of owning stocks or the return of owning bonds or for that matter the return of owning a long commodity portfolio – one can look at additional sources of return that they classified as alternative betas. And these are returns that are earned by properly managing specific risks. For example, a person should earn an excess return if they take credit risk. To illustrate: if you buy B rated bonds over a long period of time, you should outperform the return of A rated bonds because you should be paid for taking that additional credit exposure.

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## Interview: Ernest Jaffarian Continued

The second risk they identified is a liquidity risk. One example: if you bought private equity versus traditional asset equities over time, the private equity return should outperform traditional equities because you should be paid for a lack of liquidity.

The third risk that they identified is what they called volatility risk, which could also be considered default risk. This essentially has to do with the risk that you take if you have a defined upside with a virtually unlimited downside, such as a short options position. That risk is embedded in certain strategies such as long/short equity or merger arbitrage or credit arbitrage. The managers don't try to hide that risk. Instead, they acknowledge that what they're seeking to do is take advantage of times when the markets are not acting "normally". So, when assets get out of line with each other you try to buy the cheap one, sell the rich one and wait for them to come together and earn a return. That's often referred to as taking a volatility risk. When one examines 2008, traditional assets like stocks certainly had a very difficult time. But equally important, the three big risk categories – credit risk, default risk and volatility risk – all suffered at the same time, which explains why there was such a dramatic impact on the market at large.

"...the three big risk categories - credit risk, default risk and volatility risk - all suffered at the same time"

**FOCUS:** *Had you ever seen this before: when all three of those risks cascaded downward simultaneously?*

**EJ:** Actually, we're used to seeing that in almost every instance of what I call an "economic earthquake". The thing that was remarkable about this event was the magnitude and duration of it. But if you think about other significant events like the Russian debt crisis or Long-Term Capital or Black Monday in 1987, you'll find a simultaneous convergence of all of these things. And it shouldn't surprise, because of the interrelatedness of the markets. Many people look at the volatility index on the stocks – the VIX index – as a general indicator of market volatility or market risk. Well why can you do that? Well, if there's a big move in the currencies guess what? Stocks move. If there's a big move in energy, guess what? Stocks move, and so on. As a result, it's not so much necessarily where that volatility earthquake hits, it gets reflected across multiple markets. That's why supposed diversification fails often at the most critical moments.

What's unique about the managed futures space in general – and our portfolio specifically – is that we seek to identify professional traders who seek to make a profit purely based on their trading skill. No credit risk. No borrowing whatsoever. A long synthetic long options profile (rather than a synthetic short options profile) and a high degree of liquidity. So if you give up the return embedded in traditional data or in taking credit risk, liquidity risk or volatility risk, you're simply left with this trader's skill aspect. As a result, the areas that suffered in 2008 were not a liability for our portfolio.

**FOCUS:** *Because through your careful oversight you had pruned away those other factors and settled in on pure trader's skill?*

"It was an unusually good market for pure trader's skill"

**EJ:** That's right. On pure trader's skill. Then, you take a look at the markets and you say: "Was this an environment that gave traders a good opportunity?" It was an unusually good market on those terms. A simple example: traders found a tremendous opportunity to make money as crude oil went from $40 a barrel to $140 a barrel. But they also found a great opportunity to make money when crude oil went from $140 a barrel back to $40 a barrel. So you had these massive moves in the marketplace across multiple sectors that created an unusually strong environment for trader skill opportunity. This proved to be good for the industry at large, and specifically for us.

**FOCUS:** *It sounds as if this approach has been a hallmark at Efficient from its very beginning. We presume you didn't develop this solution in response to the times, but crafted it as the foundation of your business model.*

**EJ:** Yes, that's correct. I was asked recently, "How did you know to anticipate building a portfolio to avoid a lot of these risks?" And the short answer is: we didn't do that at all. What we tried to do was build a portfolio that maximized the unique benefits of the managed future space. If you invest in funds for example, it still might be a very good investment but you're taking perhaps some liquidity risks or transparency risks that you don't need to take if you run a managed account program. If you use only segregated cash management and the managers themselves have no access to cash, you run a cash efficient program, which is where our name came from. But it also has the benefit of not leaving cash exposed to the credit of the institutions. So our approach wasn't in anticipation of potentially dangerous events in the future, but rather just a desire to maximize the opportunity as the structure allows.

**FOCUS:** *Has that approach, predicated so strongly upon the aggressive management of risk, been one of your core beliefs, even prior to your founding of Efficient?*

**EJ:** Absolutely. I came out of the options trading world with CRT and later with Hull Trading Company. If you understand options market making, you know that you have to do two things well: first, you better understand how to run your portfolio mathematically well; and, second, you better know how to actively manage risk well. Those two concepts have been embedded in Efficient from the very beginning. You do things that are mathematically sound and you actively manage the risk. That's why one of the important reasons we only use managed accounts is because it's one thing to observe your risk, and quite another thing to be in a position to respond to it. When you actually control every position in the portfolio, you are in a position not only to see and manage those risks, but to respond to them should there be a need to do so.

**FOCUS:** *So Efficient was poised to seize upon the opportunities that presented themselves in a churning marketplace. As you surveyed the landscape over the last couple years, did you observe behaviors in the market that suggested others were exposing their investors to undue risk? Or were you focused solely on your own business?*

**EJ:** Well I'll answer that question in two ways. First, while I'd like to think that I was brilliant and foresaw all of the things that were going to happen, the truth is that I was pretty much in the category of everybody else. What we saw occurring in the home mortgage market and the kind of loans that were being made available to people and so on seemed to be economic craziness. But I never anticipated the magnitude of the problem that would evolve from that. So the second part of the answer is more important. And that is: I have an embedded belief that there will always be financial earthquakes. I think it's so easy to fall into the position that things are just fine and things are going to go on in the future as they have gone on in the past. The risk is not thinking of an earthquake as a normal event.

While some might say that earthquakes aren't normal, you need to ask the question another way: will there be more earthquakes? The answer is: of course! So we know they're going to occur – but with an unknown period of time between events. If there's one lesson we can learn from the history of financial markets, it's that earthquakes happen. And almost by definition they're not anticipated. No one really saw Long-Term Capital or Black Monday or the Credit Crisis of '08. They might have had glimpses or thoughts but the magnitude of those events took the market completely by surprise. My opinion is that there are more earthquakes to come.

That said, it's a very difficult discipline to build a portfolio that seeks to take advantage of earthquakes and their aftermath. Why? Because during the calm periods, those opportunities to make money are few and far between. It becomes a real struggle to keep one's financial head above water. When those moments do arrive, however, it's a great place to be.

**FOCUS:** *Talk, if you will, about 2009.*

**EJ:** If one looks at a volatility index such as the VIX, and examines it over the course of 2009, it's almost a ski slope. It's an extremely steady downward progression in volatility. In layman's terms, we might call this a regression to normalcy. That's a very, very difficult environment for trading strategies that either depend on marketplace divergence or seek to harvest volatility. Or, as we just spoke, to try to take advantage of earthquakes. At the same time, it's a very good environment for strategies that depend on normalcy. As a result, long/short equity, merger arbitrage, credit arbitrage and so forth do well in those kinds of environments. The CTA industry, while not having a horrible year, has not found opportunity to make money year-to-date in 2009. The fact that this industry has done as well as it has with

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# Commentary: On Forgetfulness

**By Pauline Modjeski, President**

While many today marvel at the resilience of the markets, especially the speed with which the investment community has rebounded from last year's implosion of the global equities, credit and debt markets, others worry that this bounce-back effect has been much too steep and has occurred much too quickly. One of our contributors to this issue of *FOCUS*, Craig S. Hurwitz, openly questions whether we've re-embraced risk too quickly. Another, Efficient Capital Management's Ernest Jaffarian, reminds us that catastrophic financial events are like earthquakes: while no one knows where or when the next might occur, to presume that there will never be another seismic calamity is to ignore history.

Over the past two decades our industry has experienced – and withstood – such earth-shattering events as:

- *The U.K. Currency Crisis* (1992), in which a failing pound led U.K. officials to raise interest rates from 10% to 12% (eventually rising to 15%), in a valiant – but unsuccessful effort to retain Great Britain's membership in the European Exchange Rate Mechanism (ERM).
- *The Barings Bank fraud* (1995), in which a rogue trader's £850 million fraud, brought down the oldest merchant bank in London.
- *The implosion of Long-Term Capital Management* (1998), which forced the Federal Reserve to orchestrate a $3.6 billion bailout by LTCM's creditors, to avoid a total collapse of the financial markets.
- *The bursting of the "dot-com" bubble* (2000), which – in a two-year span – effectively wiped out almost $5 trillion of technology companies' market value.
- *The horrifying events of 9/11* (2001) that not only shut down the three major U.S. stock exchanges (NYSE, AMEX, NASDAQ) for over a week, but led to the biggest single-day decline (a 1370-point drop) of the Dow Jones Industrial Average.
- *The accounting scandals at Enron* (2001) *and WorldCom* (2002), which not only forced both companies to declare bankruptcy, but significantly disrupted the financial markets and led to massive regulatory changes.

> "...to presume that there will never be another seismic calamity is to ignore history"

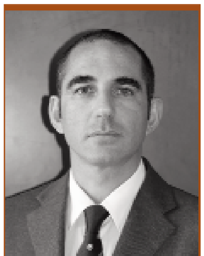
More recently, of course, the industry has grappled with the effects of the sub-prime lending crisis (2007) which morphed into the global credit crisis (2008). During this period, U.S. private debt nearly doubled, the two largest U.S. Government sponsored enterprises (GSEs) – Fannie Mae and Freddie Mac – went into conservatorship and financial institutions worldwide were pushed to the edge of survival. Finally, there was last fall's spectacular dissolution of Lehman Brothers and the Reserve's Primary Fund "breaking the buck", each of which led to billions of investor assets being diminished in value and/or frozen.

Not surprisingly, these stressors have had a profound impact on interest rates. While it's convenient to think of the interest rate environment as "flat and low" (after all, the Fed's zero to .25% target range has been in place since last December), near-term recollections can mask longer-term realities. Since early 2001, the investment community has witnessed not one but two 500-basis point declines in the Fed's benchmark rate (dropping from 6% in January 2001 to 1% thirty months later; and falling from 5.25% in September 2007 to its current zero to .25% range one year ago).

Despite the many real-world "shocks to the system" cited above (and one could easily think of many more), some lessons still don't take hold. Maybe it's because we humans are an optimistic lot, thinking things will always get better. Maybe it's because recent history is more vivid – and therefore seems more relevant – than events that took place years ago.

Whatever the underlying reasons, industry observers advise us that the hard lessons from panics and crashes tend to be forgotten when the economy recovers. As 2009 winds down and all of us look to a new year, with yet-to-be-revealed challenges and opportunities, here's hoping investors and managers alike remain ever-mindful of the past and its lessons while attending to their present business needs. ■

# "An Open Mind But A Critical Eye":
## An Interview with Anthony Gordon



Anthony Gordon

**Anthony Gordon:** I'm Anthony Gordon with Gordon Family Office. Essentially, we are capital allocators: minders for a few discreet private individuals and their respective companies in some cases. We allocate capital across the broad array of investment opportunities, which includes everything from direct investment to private equity, hedge funds and fund-to-funds, long-only managers who work with equity markets and fixed income markets and collectibles (ranging from rare photography to rare watches). We also look at real estate, commodities and, obviously, cash.

We look at the world from a global macro viewpoint, to get a sense as to where things are this morning and where they'll be tomorrow (which we define, depending on the client, anything from a 12-month to a 5-10 year horizon). For those families that include children, the horizon can be even longer. For us, in both the short and long term, capital preservation is of greatest concern. In every investment, we look to participate with the least risk possible. We understand, though, that without some risk there is little reward. We develop these themes using a top-down analysis.

**FOCUS:** *Your universe of investment possibilities seems highly diverse. Are you particularly strong in any one of those areas, or would you describe yourself as a generalist (knowing something about each of them)?*

**AG:** I don't think I'm an expert in any of them, which is why I hire people smarter than me to deploy strategies. My expertise lies in devising thematic ideas. The theme might be as simple as selecting a country whose market is at a low or near a breakout, or seems unfairly valued. We assess what opportunities lie there and with what risks. Some of these themes are short-lived. One illustration: Vietnam, which is going from having been virtually decimated in a war to a youthful and exuberant country that's on a tremendous growth spurt.

Using Vietnam as an example, we ask a variety of questions. Do we invest directly with a company, with a start-up there? Do we find someone on the ground through whom to buy individual equities? Do we find a fund manager? In Vietnam's case, there simply are not that many managers open to foreign investors. We do our best to identify top talent, to examine their data and – if they pass that test – to meet them in person to really understand their strategy and to assess if this is the best way to embrace the opportunity.

We'll also calibrate the risks implicit in hedge funds that might have lesser liquidity than a vehicle that trades daily on the AIM in London. We manage risks both within the theme and to ensure against overweighting within the entire portfolio. As a rule, we try to have at least two – and ideally, four – managers embracing the same idea. From a non-correlated return aspect, that's proven quite effective.

**FOCUS:** *It certainly sounds principled and comprehensive.*

**AG:** It is. We happen to like going "outside of the box". For over 10 years, we've invested in countries like Russia, South Africa, China and India. But as others become familiar with managers we've researched, we're constantly looking for as-yet-unidentified talent: who's new, who's spun off from one place and what added value they might provide.

> "We happen to like going 'outside the box'."

**FOCUS:** *Does your family office deal with multiple sources of money, rather than a single family? Are you actively seeking ultra-high net worth individuals and families?*

**AG:** That's a good question. Historically, all the members have been directly family-related, either once or twice removed. When not a direct family member, it's been a spouse's relative or a spouse's company. Recently, we've taken on a client who is completely unrelated to the family. But this happens very organically and only after a great comfort has been achieved. Essentially, it occurs only after we've provided free advice for a few years and the individual understands that we do things differently than most. It's not something we've actively pursued.

**FOCUS:** *That would seem to be a great model for success: proving your worth through trial, while demonstrating fit as well as functionality.*

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## Interview: Anthony Gordon Continued

**AG:** It's interesting that one achieves popularity or relevance only after outperforming others who were perceived as being bigger, smarter or more valued than you. We've learned, though, that if you demonstrate how your approach preserves capital or provides less risk – particularly during stressful times – then you become relevant. When you advise someone that they're doing something wrong at a time when their strategy appears to be working, they don't really listen. But when circumstances change in a vicious, violent fashion (as the markets did in the past year) and they lose 40% of their investment in a very short space of time, they show real interest. Our judgment is that today's short guy is tomorrow's bull. And today's bull is tomorrow's short.

**FOCUS:** *How did the turmoil in the global markets challenge you over the past 18-24 months?*

**AG:** In a real sense, the past 18-24 months are an irrelevant period. What's more relevant are the decades of enormous liquidity, cheap money and manipulated interest rates that preceded last year's collapse.

> "...the degree to which the markets collapsed was not surprising but the pace was."

We think of last year's financial crisis in Hollywood terms. The financial markets here, Wall Street and our system of capitalism created this fantastic movie. The rest of the world (as they always do, you know) followed suit and were very much game to attend the movie, buy the candy and get a big rush off the sugar high. And then, when the film came to an abrupt halt, the worldwide audience had to unite, recognize the consequences and assume proportional responsibility. It's not as if there weren't critics of that movie: Nouriel Roubini, Paul Krugman and others openly discussed the flaws and impending disasters of the global economy. From our perspective, the degree to which the markets collapsed happened was not surprising. But the pace at which it happened was. I'm proud to say that we had anticipated things rather well. Beginning in early 2008, we began to exit our long-only equity positions rather aggressively, moving into cash.

In truth, we thought the end of the preceding year (2007) felt very strange: not unlike a car without brakes. Now we're seeing an unprecedented correlated rise in most asset classes, with the exception of CTA's not having a great year. Since it's not normal for widely diverse asset classes to rise in tandem, how does one embrace this market? We think it's important to have a cash position that's in the 20-40% range.

**FOCUS:** *So your counsel, from a family office perspective, is to keep 20-40% in cash for ready liquidity.*

> "...it's essential that one's new investment dollars aren't going toward legacy positions that still face huge distress."

**AG:** Correct. Having "dry powder" is a very good thing these days. But it's essential that one's new investment dollars aren't going toward legacy positions – real estate, for example – that still face huge distress. We believe there are still good opportunities, though. In the hedge fund space, we want to make certain that the fund managers have absolute best integrity. We need to be assured that the operations have exceptionally good risk controls, that there's total transparency. We look to see how many funds a particular manager is involved with. Managed accounts are important, too. And we definitely want to own a good chunk of CTAs or CTA fund-of-funds.

**FOCUS:** *That sounds like a prescription for smart management of risk.*

**AG:** Yes, we look at risk management as two-pronged. It's not just the trading risks, but the operational risks baked into the system. If there's a positive development from last year's market collapse, I think it's the breakdown of closed system architecture, which in my mind was a key contributor to this mess. Among the big players, we're beginning to see outsourcing replace captive in-house services in the big players. In part, this move reflects the influence of impartial groups like ours that can freely choose to go anywhere and select those providers who make the most sense. It's always useful to evaluate risk in the context of performance. When we look at some of our more balanced type long-only managers, they have returned – through end of September – about 25% this year whereas the S&P is up about 19% in the same time and the MSCI about 22%. Importantly, our 25% has been achieved with far less risk than either of those two indices.

**FOCUS:** *Do your investors value your approach to managing risk?*

**AG:** I think clients have very short minds and they generally measure you by last month's performance. You need to outperform the market and you need to have absolute returns. That's the hard reality. The importance of liquidity, however, has led to a bit of a skewed world these days. Some funds that had posted strong performance had the largest redemptions because they had great liquidity and could return money at short notice.

**FOCUS:** *So what's your assessment of today's investing climate?*

**AG:** It used to be market movement could be defined as up, down and sideways. I think a new descriptor has emerged: extreme. This is a time of extreme market shifts that move with unequalled rapidity and speed. Investor sentiment that used to take months or years to form now takes place within hours, minutes. In some ways, it's an upside-down world, which leads to some unexpected ideas. For instance, we believe that emerging markets in many ways are safer today than they've ever been and safer than the U.S. market. We see value in a net exporter like Brazil. And we see value in South Africa. When one looks at the JSE (Johannesburg Securities Exchange) you see simple companies that are well-run that make real things. They're cash-rich, with not much debt and less-inflated P/E's than similar companies here in the U.S.

> "...it's an upside-down world, which leads to some unexpected ideas."

**FOCUS:** *So, gazing into your crystal ball, Anthony, is the recession over?*

**AG:** Actually, I believe that the recession is far from over. I do a fair amount of business traveling. And I've found that when you journey anywhere within an hour of a major metropolitan city within the U.S., you'll see a dramatic change in how people exist. There's an element of great despair. You see empty shops, vacant real estate, fewer people: in all, a lot less activity. The numbers tell us there's high unemployment, mortgage payments are late, credit card delinquencies are up, auto sales are down. But I see genuine human suffering. Yet, when you visit the world's financial centers – Wall Street, London, Shanghai, Tokyo – it's almost as though that other 'real' world doesn't exist. There's great disconnect between Wall Street and Main Street.

**FOCUS:** *When do you think things will truly turn around?*

**AG:** I think that we could be in for many years of sub-par growth until we acknowledge that we have to make something and that we have to be leaders and not followers. Until that happens, I think we're in for an extended period of hard times. America has a marvelous history of converting possibilities into accomplishments. We simply need to rediscover those qualities. Specifically, there are tremendous possibilities here for mining certain natural resources, for growing and harvesting food.

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> "America has a marvelous history of converting possibilities into accomplishments."

# "How Quickly Markets Can Become Illiquid": An Interview with Mike LeVar

Mike LeVar

**Mike LeVar:** My name is Mike LeVar. I'm the Director of Hedge Fund Research at Hammond Associates. Hammond Associates is an institutional fund consultant, serving pensions, endowments, foundations and private wealth clients. Our clients have a little over $50 billion in assets. I am in the hedge fund area, with responsibilities for about $4.2 billion in assets. Roughly three-quarters of this total ($3.2 billion) is in direct hedge fund investments; the balance ($1 billion) is channeled toward funds-of-hedge funds.

Our clients are predominantly endowments and foundations. We also have a significant pension practice, and growing private wealth and healthcare practices.

**FOCUS:** *How were you and your colleagues challenged during the past 18-24 months of market turmoil?*

**ML:** From a hedge fund perspective, our historical philosophy has been to invest in low leverage strategies. As you know, many of the issues that developed last year were pervasive throughout all sectors of the market. While these issues were more dominant and illiquid in higher leverage strategies, they filtered throughout the entire marketplace so it definitely had an impact on us. Going into 2008 we were already concerned about the possibility of credit spreads widening and resultant illiquidity. As a result, we had hedged client portfolios via short credit. The primary lesson of last year was the speed at which certain assets became illiquid. For example, we were surprised by the issues and illiquidity in the commercial paper market.

Our firm began applying hedging strategies to client portfolios in 2005, when credit spreads were tight. We've been doing it ever since, and it really paid off last year. If you had told me at the beginning of 2008 that the VIX (the CBOE Volatility Index) would hit 80 before year-end, I would have considered that borderline mathematically impossible. After all, before last year, 30 was a big number. 80 was inconceivable: an implausible, horrible scenario.

"The primary lesson of last year was the speed at which certain assets became illiquid."

**FOCUS:** *Take us inside your company, if you will. How do you and your colleagues handle those swift-moving, unanticipated market movements?*

**ML:** We have a dedicated team that expressly researches capital markets. I participate in that group and provide a hedge fund perspective. The guiding principle of our firm is long-term mean reversion on a valuation basis. We constantly seek asset classes that are inexpensive. We tilt client portfolios that way and constantly rebalance, so as to provide the least expensive portfolio on a diversified basis. When credit spreads were exceptionally tight in 2005/06, the fixed income component of client portfolios was geared towards treasuries. Even though some may have not thought these very attractive, we simply didn't believe investors were being fairly compensated for taking on credit risk. Last year, as credit spreads blew out towards unprecedented levels, we shifted client portfolios more towards actively taking credit risk.

As to how often we meet: during the crisis we had team meetings – including the capital markets group and all our heads of research – every morning. We did this to make sure everyone stayed fully informed so that our client communication was consistent and always up-to-date.

**FOCUS:** *Tell us a bit about how your clients responded during those extraordinary market stresses. Did their sentiments and actions mirror those of other institutional investors?*

**ML:** With over 200 clients whose investment ambitions are all along the spectrum, we saw a variety of responses. Some actively asked us to seek out opportunities during the crisis. Others said, "we're very worried; take us to a very low-risk portfolio". While we've always emphasized prudence, we expressed that more formally at the beginning of the crisis. We recommended to a number of our clients that they should put 12-18 months of planned spending into a segregated cash account, so their operational plans wouldn't be compromised in the short run. While it's always sensible to have some assets positioned defensively, if you're worried about funding issues it's essential to have your assets and liabilities matched up.

> "...if you're worried about funding issues it's essential to have your assets and liabilities matched up."

**FOCUS:** *So the recommendation your firm made to many of its clients last year was, "keep one year's spending available and keep it in cash"?*

**ML:** Yes. The crisis also led to renewed discussions about re-evaluating risk within the portfolio. We've always provided clients risk reports that outline a "worst-case" scenario, based on historical norms and standard deviations. But when that "worst-case" scenario becomes real, it's an entirely different psychology at work. The suddenness and magnitude of the losses shocked a number of our clients. But we used that situation to re-evaluate risk tolerances and to make certain that each client was comfortable with their positions.

**FOCUS:** *In those stressful times, did clients actively seek your thinking and insights? Or did they instead direct you, "this is what we'd like you to do"?*

**ML:** I'd describe it as a very collaborative effort. We have exceptionally good clients. During the crisis period, they listened well, had meaningful input and generally made investment decisions that mirrored what we thought was in the best interest of their respective portfolios. One thing that our clients have found helpful: when we perform our risk analyses, we look at long-term volatility for a variety of asset classes. Last year, we added analysis using short-term volatility (at the time, a substantially higher figure) to calculate risk. We advised clients of the consequences of this materially higher volatility, which they really appreciated.

**FOCUS:** *Let's discuss the lessons that your firm came to understand during this wildly unpredictable market.*

**ML:** The most important lesson was our realization of how quickly markets can become illiquid. We thought that, with our long-standing position in short credit, we were well-positioned to outperform in a credit crisis. We underestimated the depth of that crisis, though. As a result, when the market became so illiquid, we used it constructively to reassess asset/liability mismatches and to prepare a recommendation to move some money to cash. This was particularly meaningful for those clients worried about the impact an additional draw-downs in market value may have on their operations. We were working on both defense and offense at the same time.

**FOCUS:** *Were you able to leverage your understandings of this tumultuous marketplace to capture new business? Conversely, did clients use market conditions as a reason to go elsewhere?*

**ML:** Historically for our firm, the 4th quarter is typically pretty busy. Many groups prefer to have a consultant in place at the beginning of the new year so the 4th quarter is usually quite active. Last year, though, all kinds of decisions – strategic investments and which outside consultants should be engaged – were put on hold. Everyone was focused on the crisis' impact on their portfolios. As a result, decisions usually made at year-end were deferred to early this year. The good news is, we've benefited terrifically.

**FOCUS:** *With 2010 upon us in less than 45 days, what themes or issues are you and your clients anticipating in the coming year?*

**ML:** Well, all of us are hopeful of a return to normalcy. Heightened risk remains of great concern, but our clients have seemingly adjusted to the current situation. Going forward, we're looking at new opportunity sets. One observation: we may be at the beginning stages of a relatively prolonged distress cycle. If true, from a hedge fund prospective we like credit funds. There still remain, however, some mark-to-market issues that, should we get into a W-shaped recovery, could lead to a return to illiquidity. Thus we have a preference towards long/short credit managers. When we talk to clients we focus on risk tolerances first. For those who can embrace this type of risk, we think it can be an attractive environment to invest in those kind of distressed-credit hedge funds. Since this could be a more prolonged distress cycle, the timing of when you make your initial investment is less important than committing to increase that participation over time. We also embrace multi-strategy managers allowing our portfolios to shift opportunistically towards credit without a client meeting.

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# "Darwinian Yet Entrepreneurial": An Interview with Peter Ort

**Peter Ort:** My name is Peter Ort. I'm the head of business strategy at Karsch Capital Management, which is a $3.3 billion hedge fund management company based in New York. Prior to joining KCM earlier this year I was the co-head of the Hedge Fund Strategies Group at Goldman Sachs where I worked for seven years.

**FOCUS:** *That must have provided you some interesting perspectives on the markets, particularly as they affected hedge funds.*

**PO:** Indeed. 2008 was obviously a very tricky year, not only in the hedge fund space but across many asset classes. There were many lessons learned during 2008 as events unfolded, culminating with the collapse of Lehman Brothers. That had a profoundly large impact on a lot of hedge funds both in expected and unexpected ways.

**FOCUS:** *Talk a bit about that period of time – the 18 to 24 months of market volatility that we're just now emerging from – and the marketplace stressors and resultant behaviors you observed during that time.*

**PO:** As has been well- documented, during the five-year period after the global economy emerged from recession in 2003, volatility steadily decreased across many asset classes. As a result, many hedge fund strategies experienced fairly limited drawdowns during that period and were able to deliver good absolute returns with low volatility. As a consequence, many hedge fund strategies became ever more reliant on leverage and also on various market correlations. Because of the liquidity present in many asset classes, many hedge fund allocators and managers began investing in less liquid securities. At the same time, many allocators offered better and better liquidity to their end investors. As a result many liquidity mismatches built up in the system. Many allocators offered liquidity terms to their investors without taking into consideration underlying hedge fund manager terms such as side pockets, gates and the like. So you had these liquidity mismatches build up in the system.

**FOCUS:** *In your judgment, were those liquidity mismatches known and overlooked, or simply not fully understood?*

**PO:** In a period of benign markets, good liquidity and low volatility, it's natural for people to extrapolate the good times into the future. There clearly wasn't enough attention paid to what could go wrong. The combination of low volatility, high leverage, high correlation, and reduced portfolio liquidity proved to be extremely toxic starting in the second half of 2007. Volatility spiked simultaneously across many asset classes. Liquidity began to drain away. Credit and leverage became unavailable. The high market correlation produced significant losses as markets began to fall from all-time highs. It's not uncommon during a financial shock or credit shock for correlations to increase. Even before the financial crisis hit, the correlations across asset classes were high. They were correlated on the way up, and equally so on the way down.

**FOCUS:** *Generally speaking, what lessons might you share on how best to oversee hedge funds during such stressful times?*

**PO:** First, it's essential to pay attention to "worst-case scenarios" before making an allocation either to a specific hedge fund strategy or to a specific hedge fund manager. It's important to assess not only whether someone's a good money maker, but to determine whether they're equally good as a risk manager and have the capability to build and to run a good hedge fund organization. If you get comfortable with all the investment-related issues, you need to look at factors such as: how do they structure their portfolio and what kind of liquidity terms do they offer investors. There should be a match between what liquidity terms are offered to investors and the underlying liquidity of the investment portfolio.

> "...you have to be absolutely convinced that there's a match between what they offer in terms of liquidity and the true underlying liquidity of the investments they're making."

Credit-related strategies in particular are very tricky in this regard. For the most part, equity long/short strategies – with the exception of small-cap or less liquid emerging market focused strategies – tend to be fairly liquid. Even at the height of the crisis, most equity markets remained fairly liquid particularly for mid- and large-cap companies. The same was true both with macro strategies and CTA strategies. For the most part, these managers were investing in fairly liquid instruments. The tricky part comes when you start dealing with credit-related strategies, and that encompasses a pretty broad swath of hedge fund strategies including distressed credit, capital structure arbitrage, and convertible arbitrage. Anything that includes corporate credit risk is more tricky to try to package and to get the liquidity terms right.

**FOCUS:** *Would you say the industry has ramped up its examination of the risk management and liquidity components?*

**PO:** Definitely. That's almost always the case when coming out of a crisis like this. Investors and regulators alike tend to sharpen their pencils and look more critically at things. There can be a tendency to go too far in that regard, though: to shy away from less liquid investments and potentially miss out on some very interesting investment opportunities. It's clear, though, that hedge fund allocators are now much more focused on liquidity and on risk management. And it's not only investment related risk that's drawing attention, but operational risk. The industry is vastly more focused on these things than it was two years ago.

> "...hedge fund allocators are now much more focused on liquidity and on risk management."

**FOCUS:** *For years it's been acknowledged that operational risk management is all too often overlooked or undervalued in terms of its potential for disaster. EDHEC's 2004 study affirmed that 8 of the 10 largest hedge fund failures had their roots in operational weaknesses. Have you observed that due diligence on the operational front has improved?*

**PO:** Yes, definitely. The assumption made by some is that a fund's operations are being performed properly and with care. But it's essential to dig deeper because hedge fund investors aren't compensated for taking operational risk. Instead, they're compensated through a return stream that's generated from investment-related risk. There's no upside for investors to take operational risk. Poor operations only have downside. As a result, it's extremely important to have a strong focus on that area.

**FOCUS:** *And are sufficient tools in place to render those assessments? Are you able to go "under the hood" and really see what's going on operationally?*

**PO:** Yes you can. Whenever an allocator chooses to outsource the management of money – whether selecting a traditional long-only manager or a hedge fund manager – it's important to perform detailed operational due diligence. There are many independent third parties and outside consultants that not only can help in this area but focus expressly on it. While it's not a revelation to many that operational due diligence matters, coming out of the crisis people are certainly re-focusing on it. This is particularly true in light of some of the high-profile frauds that were revealed during the financial crisis. When you see a return stream over a very long time frame that simply looks "too good to be true", it merits careful scrutiny. In the Madoff case, it wasn't a situation of a manager delivering extraordinary returns. Instead, the investors believed they were getting steady returns with extremely low volatility and drawdowns, regardless of the prevailing investment climate. This was an example of something looking "too good to be true".

While there were certainly a number of managers who did a poor job of managing risk and of protecting capital, it's important to remember that – when you're allocating to hedge fund strategies – it's a mixture of alpha and beta that you're allocating to. I think that hedge fund allocators and investors should consider hedge funds not as a standalone independent asset class within a broader asset allocation, but as components of traditional asset classes. So when you're evaluating opportunities such as equity long/short or equity market neutral or statistical equity arbitrage, you should think about them in the context of the "passive/active spectrum" of equity-related strategies. These would include not only traditional long-only equities but flex equities, which are 130/30 strategies. Similarly, with distressed credit and

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# "Intellectual Flexibility Is Essential": An Interview with Craig S. Hurwitz

Craig S. Hurwitz

**Craig S. Hurwitz:** I'm Craig Hurwitz and I'm the managing principal of Portus Advisors. We're a relatively new independent financial and investment consulting firm, having been around since the fourth quarter of last year. Our primary purpose is to help sponsors of large investment pools design, implement and maintain successful banking and investment programs through objective asset-based consulting. We work chiefly with endowments and foundations, retirement plans, public and corporate treasury and high net worth individuals.

**FOCUS:** *Are any of those groups more central to your business mission than the others?*

**CH:** I have a lot of experience on the institutional side. While I've worked with all four of our targeted audiences, my most significant investment management experience lies in the world of endowments and foundations, providing consultative services. I'm also deeply experienced on the treasury side in cash management. I've done substantial money management in those areas over a pretty long period of time.

**FOCUS:** *Obviously, the past 18-24 months have been extraordinarily tumultuous in many sectors and across many asset classes. What are the key challenges that confronted you, your firm and your constituents during that timeframe?*

**CH:** Well, as a recent start up, we found ourselves in a rather enviable position because we weren't associated with the problem in many cases. Because we weren't married to any particular strategy prior to this blow up, we've been able to present "outside the box" solutions more readily than others. From a big picture perspective, we've been buffeted by a massive corrective process that's been triggered by a hugely over-leveraged private sector. And when I say private sector I'm referring specifically to the consumer segment. Owing to the nature of the problem, I remain unconvinced that the typical levers that the Fed has traditionally employed will work this time around. The most appropriate comparisons to our current struggles are probably the U.S. in the 1930's and Japan over the last 20 years. It's taken Japan more than 15 years of huge de-leveraging to address its economic problems. As the U.S. goes through this de-leveraging process, I think it's going to take quite a long while, too. To make up the slack, the government is likely to continue deficit spending on a massive scale to maintain what will likely be to flat to modestly positive GDP growth rate.

> "I remain unconvinced that the typical levers that the Fed has traditionally employed will work this time around."

**FOCUS:** *How long do you see that unwinding period to last here in the U.S.?*

**CH:** Well, it took a solid 15 years in Japan. And it took World War II to truly bring us out of the Depression. The implication for us is that we're going to have to deal with a "new normal". For the better part of my career – and I started in the business in 1983 – the investing environment has been extremely optimistic. The "new normal" is likely to be quite different. Economies all around the developed world are going to grow more slowly. Our government is certainly going to play a more central role, both by virtue of its deficit spending and with greater, more intrusive regulation. Near-term, I see corporate profits remaining relatively static. And consumers – who represent more than two-thirds of our GDP – are going to continue saving, rather than spending. This is a dramatic departure from the behaviors of the past two decades. Bottom-line, the "new normal" suggests a decidedly less friendly environment for investors, for employment and for our standards of living.

**FOCUS:** *In your judgment, how will this investing environment be "less friendly"?*

**CH:** Let me rephrase that question: how does one adapt to this "new normal"? If economies are flat and corporate profits remain static, a couple of things will assuredly happen. Markets will move sideways, not up or down. The smartest and most accomplished money managers will have to demonstrate three core talents: be opportunistic, display great tactical skills and, most importantly, be intellectually flexible. To illustrate that last point: the market circumstances of the past year and a half have prompted many to question their allegiance to the efficient market hypothesis. There's an awful lot invested in our industry for this theory and its practice. I haven't given up on it just yet but, we've seen enough to seriously question whether the theory over the long run, really works.

**FOCUS:** *That's an interesting observation that mirrors what others have said: time-honored hypotheses and operating principles coming under extraordinary scrutiny and serious intellectual questioning. Do you think that of the efficient market theory?*

**CH:** I absolutely do. I believe the primary fault or vulnerability of the theory lies in the assumption of rationality. As we've seen, there's quite a bit of emotion that drives decision-making, particularly when markets are going down. History also suggests that markets correlate more greatly as markets move down. It makes one question the concept of diversification, but I'm not willing to give up on it yet. I believe that diversification still works, but with so many asset classes declining synchronously, sometimes diversification softens – rather than eliminates – a negative return.

**FOCUS:** *You mentioned earlier about the 'best of best' managers needing to be opportunistic, tactical and intellectually flexible. Since it's been several generations since we've experienced such dramatic market conditions, are you confident in today's investment manager displaying that ability to adapt and change?*

**CH:** They'll simply have to be. Intellectual flexibility will be essential for managers to succeed in this "new normal". If (and only if) a manager adapts, will he be able to survive. There's no doubt that the financial industry – particularly as relates to the hedge fund community – will be more strictly regulated. With the steady proliferation of hedge funds and firms that manage hedge funds over the past few decades, there's going to be significant consolidation in the industry. Certainly the types of clients with whom I work are going to demand increased transparency. As Bernie Madoff was led away in handcuffs, the days of "just trust me" essentially disappeared. Fee structures will also undergo dramatic change. I think you'll see increased rationalization in fees. The combination of a soft economy, scant corporate profits and a sideways market will make alpha very tough to source. As a consequence, the poorer managers simply aren't going to make it.

**FOCUS:** *With fees evolving to reflect those new challenges and the burdens of increased compliance and increased regulation, the pressure on many fund managers will intensify, won't it?*

**CH:** Absolutely. If the cost side of the income statement goes up because of tighter regulations (which I think nearly all of us agree is coming to the hedge fund industry), and if fees continue to be pressured, then margins are going to go down. In an environment in which the market exerts downward pressure on fees and the alpha that some firms endeavor to source is perhaps non-existent, then many customers will head for the exits. At best the surviving firms will see their margins squeezed. But at least they will be survivors.

**FOCUS:** *Gazing into the next 6-12 months, is the "new normal" you've described a good thing?*

**CH:** I'd remove the word "good" from your question and rephrase it. I think it's a necessary thing. In essence, we're going through a normal economic condition; a correction. We've had excessive debt that needed to be wrung out of the system. However, the excess was on such a massive scale that it's going to take a very long time for companies to de-leverage their balance sheets. For the foreseeable future, I'm not sure many of them will be making decisions in ways that, for those of us who have been in the industry for 25 years, would consider "normal". They're not going to be profit-seeking or investing in their businesses to the extent that a rational investor might presume. Instead, we'll see firms making decisions driven by minimizing the debt on their balance sheet. And that's a behavior that will surely take some getting used to.

**FOCUS:** *Talk a bit about pensions, endowments and foundations. This group of institutional investors arrived somewhat later to the alternative investment party than did others.*

**CH:** That's true. If you look at the universities, at the top of the pyramid you have the Harvards and Yales and Stanfords of the world. They were early adopters of alternative investments, having invested in the sector for well over the past decade. I have several smaller university clients whose long-term objective is to achieve 50% allocations to alternatives. But they're not seeking to

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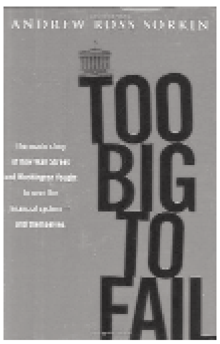
# From the Bookshelf

### Too Big to Fail: The Inside Story of How Wall Street and Washington Fought to Save the Financial System... and Themselves

**By Andrew Ross Sorkin**

Viking Penguin, 624 pages (2009)




If Dan Brown ("The DaVinci Code") or the late Robert Ludlum ("The Bourne Identity") were to write about last year's financial crisis, the resultant novel wouldn't have been more exciting, dramatic, provocative and fascinating than Andrew Ross Sorkin's "Too Big to Fail". A rip-roaring page-turner, "Too Big to Fail" chronicles – in moment-by-moment fashion – the behind-the-scenes actions of the world's most powerful financial executives and regulators as they race against the clock to try to keep the world's financial systems from total collapse.

In crafting this tale, Sorkin, the chief mergers and acquisitions reporter for the *New York Times* (and creator of the financial news website, *DealBook*), has drawn upon more than 500 hours of interviews with more than 200 people who participated directly in the events surrounding last year's meltdown of the financial markets.

The result is a book filled with extraordinary detail: not only about the key players and their respective backgrounds, but about the settings and circumstances in which these remarkable deliberations and decisions took place. A lively and entertaining book, rich with anecdotes, "Too Big to Fail" is more reminiscent of a blockbuster thriller than a historical review of the largest financial dislocation in economic history.

Some excerpts:

Dick Fuld (CEO of Lehman Brothers, the fourth-largest firm on Wall Street), replayed the events of the past weekend over and over again in his mind: Bear Stearns, the smallest but scrappiest of Wall Street's Big Five investment houses, had agreed to be sold for $2 a share. When Fuld first heard the $2 number from his staff in New York, he thought his airplane's phone had cut out, clipping off part of the sum.

Joseph Cassano, who became head of AIG's Financial Products unit in 2001, pushed the company into the business of writing credit default swaps. By early 2005, it was such a big player in the area that even Cassano had begun to wonder how it had happened so quickly. When in August of 2007 credit markets began seizing up, Cassano was telling investors, "It is hard for us, without being flippant, to see a scenario within any kind of realm of reason in which we'd lose $1 in any of those transactions."

Alan Greenspan had one suggestion about the housing crisis, but it was with a rhetorical flourish befitting his supply-and-demand mindset. He suggested that there was too much housing supply and that the only way to really fix the problem would be for the government to buy up vacant homes and burn them.

"We've got to get some foam down on the runway!" said Timothy Geither, then-President of the Federal Reserve Bank of New York, when imagining the impact Lehman Brothers' dissolution would have on other major financial institutions.

Unlike a prototypical best-seller, there's really no single protagonist in "Too Big to Fail". Instead, readers are introduced to a diverse and fascinating collection of high-profile executives from the nation's largest investment banks, hedge funds, law firms, various regulatory organizations (i.e. SEC, FDIC, Federal Reserve, Treasury Department, Financial Services Authority) and the U.S. Congress.

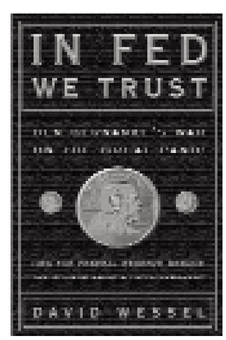
It's been said that "surmounting difficulty is the crucible that forms character". If so, "Too Big to Fail" reveals the full range of human responses to crisis – from extraordinary creativity and hard work, to petty jealousies, selfishness and arrogance.

"Too Big to Fail" captures all these emotions as they play out against the backdrop of the biggest economic crisis since the Great Depression. If you want the definitive story of last year's near-collapse of the financial markets, we heartily recommend "Too Big to Fail".

### In Fed We Trust: Ben Bernanke's War on the Great Panic

**By David Wessel**

Crown Business, 336 pages (2009)




*"Storytelling hints at a fundamental human unease: human imperfection. Where there is perfection, there is no story to tell." – Ben Okri, Poet and Novelist*

"In Fed We Trust: Ben Bernanke's War on the Great Panic" is storytelling at its best. While the tale focuses on the actions of the Federal Reserve Chairman's efforts – in concert with then-Secretary of the Treasury, Hank Paulson, and then-President of the Federal Reserve Bank of New York, Timothy Geithner – to prevent an all-out collapse of the U.S. financial system, its central theme is how the Federal Reserve became the fourth branch of government.

Author David Wessel, economics editor of the *Wall Street Journal* and co-recipient of two Pulitzer Prizes, writes in a style that's both extraordinarily detailed yet very accessible. The behind-the-scenes look captures the humor and humanity of our nation's senior-most economic leaders.

Examples: "As he was being considered for the post of Federal Reserve Chairman, Bernanke – a lifelong academic – reflected that he had never worked on Wall Street, in government or in business. When asked, in his final interview with President Bush, whether he had any political experience, Bernanke replied: 'Mr. President, it won't count much for this office, but I've served for two terms as the elected representative on Montgomery Township's school board.'"

"Tim Geithner was a lithe marathoner and tennis player who looked younger than his forty-seven years. His good looks landed him on *People* magazine's 100 Most Beautiful People list. His youthful appearance not only made him less threatening to big-ego superiors, but led some interlocutors to underestimate him."

"In Fed We Trust" documents the events that led up to, and followed, the remarkable seven-day period in mid-September 2008 in which:

- Lehman Brothers filed for bankruptcy
- Merrill Lynch and Bank of America merged
- AIG was nationalized
- Goldman Sachs and Morgan Stanley were converted into Fed-protected bank holding companies
- Tens of billions of taxpayer money were committed to halt a run on money market mutual funds

With human imperfection at the core of this cautionary tale (in a moment of reflection, Bernanke notes that "we did the best we could with the powers we had"), "In Fed We Trust" is a captivating narrative of one of the most dramatically periods in American financial history.

## The Road Ahead for the Fed: A Collection of Essays

Hoover Institution Press, 225 pages (2009)


Michel de Montaigne, the French Renaissance writer who popularized the essay, defined it as "a short discussion of any topic, with a strong personal point-of-view." In "The Road Ahead for the Fed", twelve distinguished authors – ranging from George P. Shultz (who held three Cabinet positions – Secretary of Labor, Treasury Secretary, Secretary of State) to Myron S. Scholes (Nobel Prize winner and co-originator of the Black-Scholes Model for pricing stock options) to Sir Andrew Crockett (President of J.P. Morgan Chase International and a member of the Group of 30, an international body of leading financiers and academics) – share their thoughts on what the Fed's next actions should be.

While the individual contributors are united in their belief that "extraordinary times call for extraordinary measures", they differ dramatically in their assessments of past decisions and their proposals for future actions. Federal Reserve Board Vice-Chairman, Donald Kohn, explains the Fed's rationale for its unprecedented actions and addresses the many potential risks the Fed hopes to avert. Myron Scholes looks at market-based mechanisms and proposes new ways to reduce vulnerability from volatility, leverage and government guarantees. Sir Andrew Crockett argues the need for a systemic stability regulator (SSR). Crockett also insists that such a regulatory body must be separate from, and not under the governing power of, the Fed.

Aldous Huxley once remarked that, "a collection of essays can cover almost as much ground, and cover it almost as thoroughly, as can a long novel." "The Road Ahead for the Fed" does just that: sharing the perspectives of some of the brightest and most experienced financial experts of our time. It's a collection rich with insight, wisdom and provocative ideas.

## Interview: Ernest Jaffarian Continued from page 3

such an amazing contraction of volatility is frankly quite surprising.

Now where does that leave us today and what about the future? I am constantly amazed at how quickly people think everything is just fine. How quickly people develop a trading strategy and philosophy that suggests there's not another earthquake on the horizon. Today, volatility today has come all the way back to 1st Quarter 2008 levels. Do we really believe that the world is far more stable today than it was then? My opinion is that the world is poised for some significant economic events. With so many countries printing money and spending money, these currencies are going to have to rebalance against each other at some point. I think this could potentially occur in some dramatic ways. But it's not limited to currencies: we could talk about energy or precious metals or almost any other major sector, and there's good reason to think that there could be increased activity in volatility.

**FOCUS:** *One year ago, many were wringing their hands and wondering if financial Armageddon was near. Now, just 13 months later, industry experts extol the resiliency of the markets and the "spring back" effect they've demonstrated. Is this undue optimism at work? Are we too quick to re-embrace risk?*

**EJ:** I think so. But let me attack that question in two ways. When I think about the future, for the type of trading style that we employ, we make an attractive return generally and do just fine when volatility is stable. We do exceptionally well when volatility is increasing. What do I think going forward? I believe the probability of volatility dropping even lower – which we all know is possible – isn't very probable. We're already back to 1st Quarter 2008 levels, and I'd be very, very surprised if the markets are willing to push that much further. In fact, there's evidence in the markets in the last couple of weeks to suggest that perhaps even volatility might start to go up a bit after that.

> "I am constantly amazed at how quickly people think everything is just fine."

But here's what I think is dramatic about the past year. There is a remarkable history of academic writing on the subject of managed futures' role in a diversified portfolio. Beginning with John Lintner in 1983 and continuing to the present, almost every two or three years there's another academic piece on this subject. The most recent is the CME's article, "Lintner Revisited" (published in June). Each of these papers comes to absolutely the same conclusion: any portfolio of stocks and bonds (and in some cases, hedge funds) benefits at virtually any level of risk with the addition of managed futures. Sadly, on a portfolio level, people haven't really reacted to that consistent finding.

**FOCUS:** *And why is that?*

**EJ:** I think it's a combination of things, but underneath it all there still is a fear of futures as an asset class. I think there's also a belief that it's very, very hard to allocate to something where you don't see the actual asset. In other words, if you invest in the stock, you own a piece of a company. If you invest in a bond, you have a real asset. Even in a long commodity portfolio, you own a share of oil or a share of corn and that's a tangible thing. In the financial world, though, you can't have your cake and eat it too. If you want pure trader skill then you can't have the asset, because if you have the asset then you're getting the beta. So you have to make an investment decision. The academics, who simply look at the numbers and have no concern about what is the source of return, don't have any problem making the conclusion that you need to include this.

Interestingly, people invest in trader skill all the time. If you invest in a stock index as one investment and in another investment invest in a long-only manager, what you're really saying is I think the long-only manager can return the beta of the stock index and by adding trader skill could produce an excess return. So they're really investing in trader skill. They just don't think of it that way. They think of it as a stock investment. What we're trying to do is to isolate the trader skill so that we don't have a return that's subject to either traditional or alternative betas.

Let me return to 2008: what was so dramatic about last year is that there was a systemic change in the way people think about managed futures as an asset. Over 30 years of academic research compelled people to say, "OK, I get it. I need some of this diversifying asset. Not just to create a real expectation of positive return, but also as a way of mitigating the risk that's embedded on the beta or alternative beta side of the equation. I need something that can profit when those kinds of assets are finding it difficult." What we're seeing is that where people used to make their investment pie chart and say, "I want so much in stocks, so much in bonds, so much in hedge funds", now we're seeing an actual managed futures slice in those pies. People used to say that they had some managed futures in their "fund to funds" portfolio. But people have come to see – as a result of 2008 and this accumulated research – that managed futures is unique unto itself and needs to be considered as a unique asset.

**FOCUS:** *And do you see that trend growing?*

**EJ:** Absolutely. We've had people who lost half their assets in their "fund to funds" portfolio last year who increased their assets with us. We asked how did that happen? And they said, "Managed futures has become its own asset allocation area for us and so even though we lost half our assets, the managed futures portion of the portfolio has more than doubled."

**FOCUS:** *That sounds like a decision driven by the numbers. Are those who come to Efficient displaying, with greater frequency than ever, this sort of data-based decision making?*

**EJ:** The short answer is yes. Here's the difference that I see: people used to display a sort of timing mentality ("now's a good time to invest in managed futures; now's a good time to get out of managed futures"). What we're seeing now is that people are looking at it as a strategic allocation. Actually, in a year like 2009 – when performance has been flat – people are saying, "this is a strategic time to be building my managed futures allocation and my total investment portfolio." In the past, it was pretty simple. If performance was flat or negative, you lost assets; if performance was positive, you gained assets. We're now seeing a much more reasoned approach toward the investment, based on the belief that a strategic allocation is needed at all times because (and these are my words) "I know financial earthquakes come and I need to be balanced and ready."

**FOCUS:** *Thank you, Ernest. Do you have any closing thoughts or observations you'd like to share?*

**EJ:** Well, I'd like to make one last comment on this financial earthquake statement, because I think people sometimes get the wrong idea. Managed futures hope to do well when the ground is shaking violently. But what we know about earthquakes is: first comes the earthquake, then comes the tsunami. The tsunami could be likened to the wave of volatility moving forward. The bigger the earthquake, the bigger the tsunami. The CTAs opportunity doesn't necessarily come on the day or the week of the earthquake. The CTAs opportunity is riding that tsunami wave. This is the period when the markets seek, over a period of time, the new appropriate equilibrium that properly reflects the economic realities of the world as they now exist. That's why these earthquakes generally translate into longer-term opportunities for the CTAs.

**FOCUS:** *As you've stated, earthquakes will happen, but no one truly knows when, where or of what magnitude.*

**EJ:** Indeed. An interesting question that a person can ask themselves is: "Do I honestly believe there will not be a significant economic event in the next 12 months?" The investors I talk to are unanimous in the opinion that something's going to happen, but they don't know what. It's certain, though, that we're not in the stablest of all times.

"...these earthquakes generally translate into longer-term opportunities for the CTAs."

**FOCUS:** *To your point, there is always another event brewing somewhere on the horizon.*

**EJ:** Sad, but true. But that's the world we live in.

* * *

*Ernest L. Jaffarian is founder, president and CEO of Efficient Capital Management, a trading platform that specializes in liquid, alpha-generating, multi-trader portfolios. Efficient is headquartered in Naperville, IL. Its website: www.efficientcapital.com.*

## Interview: Anthony Gordon Continued from page 7

To stimulate the economy and turn things around, I think we need to adopt a much more aggressive, "out-of-the-box" approach to certain conventions. For instance, interstate laws should be re-examined to enable us to focus on a true United States and less self-interest. The government shouldn't concentrate its economic stimulus programs on the biggest companies. Where the money really needs to flow is to entrepreneurs and small business owners. Recessions end when employment improves. And historically, the best source of hiring comes from small-to-medium-sized businesses. These firms are suffering the worst in our current economy, and they should be fixed first. When they grow, people land jobs, spending improves and optimism replaces suffering. We're in the midst of a period of great re-evaluation and re-balancing.

As part of that, we're going through a process of intense re-regulation. In my mind, the goal shouldn't be massive regulation but sensible regulation. If regulators simply enforced the rules already in place, we'd probably have avoided some of the mess we've found ourselves in.

"...the goal shouldn't be massive regulation but sensible regulation."

"It's important to maintain an open mind but to look at things with a critical eye."

**FOCUS:** *Within your portfolio, are there any places where you're beginning to see things show signs of sustained improvement?*

**AG:** On a global macro-economics basis, China might be a good example. Is China on the brink of a "great lie about to erupt" or is it a true growth, highly-efficient bull market? Even though I've spent time in China, I don't know the answer to that. And I'm not sure all the managers with whom we work do, either. So our investment approach is to embrace both sides (which doesn't mean I'm long and short China; it's not easy to be short China.) I remain cautious, and I have China in a moderate state and form in the overall portfolio. As a result, if there is a precipitous massive drawdown like last year, it won't leave a dent. And if it's a great upward movement, as it has been this year, it will make a positive impact.

**FOCUS:** *We appreciate your time, Anthony. Do you have any closing thoughts?*

**AG:** I do. Everyone in our business talks about alpha. Alpha is a source or function of better information. I've observed that when investors or managers get lazy or embrace closed architecture, they do themselves a disservice. It's important to maintain an open mind but to look at things with a critical eye. You have to immerse yourself in data, spend time analyzing it and interpreting it. Education never ends in this business. In short, you have to work hard, think smartly, do your homework, ask questions and – most importantly – if you don't know the answers, find people who do. Finally, it's essential not to overcomplicate things. You have to keep things simple.

* * *

*Anthony Gordon is principal asset allocator at the Gordon Family Office, a NY-based enterprise that will launch a fund of mutual funds later this year. Mr. Gordon can be reached at anthony@gordonfamilyoffice.com.*

### Notable & Quotable

"The story of the U.S. is, indeed, one of two economies. There is a smaller one that is slowly recovering and a larger one that is still in a deep and persistent downturn. While the United States may technically be close to the end of a severe recession, most of America is facing a near-depression.

Little wonder, then, that few Americans believe that what walks like a duck and quacks like a duck is actually the phoenix of recovery."

*– Nouriel Roubini, Professor of Economics at New York University's Stern School of Business and Chairman, RGE Monitor*

## Interview: Mike LeVar Continued from page 9

**FOCUS:** *So the preponderance of your hedge fund investment universe are multi-strategy managers?*

**ML:** No, from a portfolio construction standpoint, we anchor our portfolios around multi-strategy managers. But we engage a variety of other single-strategy managers – security selection, long short equity, long short credit, global macro – as well.

**FOCUS:** *Beyond the likelihood of an extended distressed market, what other themes do you and your colleagues at Hammond Associates anticipate in the coming year?*

**ML:** From the non-investment side, there most assuredly will be new regulatory requirements that will emerge from multiple jurisdictions, both here and abroad. The managers we use believe this will likely be a "non-event", as long as the agreed-upon guidelines aren't too intrusive. By definition, increased regulatory attention will increase expenses. However, most of the managers that we recommend are already institutional quality and have a deep back office. Many are already registered. So, while new rules may add some incremental expenses, they'll also likely create higher barriers to entry that may be beneficial to our investments.

As we've discussed, we like credit. In the short term, the market volatility could be high. There is a belief at the firm that equity dispersion could also be high, so the opportunity in long/short equity investing may be attractive. One of the ways that equity long/short managers make money is the dispersion between the stocks that they're long and they're short. When correlations between different sectors or different stocks are really high, the ability to make money on a spread between a long and a short stock is diminished. When equity dispersion is high, however, there's a great opportunity for outsized returns and excellent profit. It's essential to remember, though, that with high equity dispersion the chance of negative alpha is ramped up, as well. Dispersion, in and of itself, doesn't guarantee higher returns. It simply signals an environment in which the opportunity exists.

"Dispersion, in and of itself, doesn't guarantee higher returns."

**FOCUS:** *You and your colleagues foresee that as a distinct possibility in the coming year?*

**ML:** Yes. With the VIX creeping back up around 30, there's a reasonable probability that as this crisis plays out there'll be distinct winners and losers. In such volatile environments, insightful long/short managers can do quite well. We also think that global macro investing will also be attractive in the coming year. With very active governments and the likelihood of fixed income and currency volatility remaining reasonably high, we think that global macro investing will remain attractive as well. In general, we're pretty bullish on the opportunity set in hedge funds. That said, there remain mark-to-market issues that could come into play again.

**FOCUS:** *And do those issues still remain uncertain and unresolved?*

**ML:** Yes, if illiquidity were to return in a big way, that would negatively impact hedge fund returns. Hedge funds tend to be short volatility. As a result, large or unexpected spikes in volatility can provoke investor consternation and lead to poor performance short term. Long term we feel a well constructed basket of hedge funds will generate attractive returns for our clients.

* * *

*Mike LeVar co-directs the hedge fund research unit at Hammond Associates, a St. Louis-based investment consulting firm that engineers and manages alternative investment opportunities for foundations, public pension plans and college/university endowments, as well as other institutional investors. The firm's website: www.hammondassociates.com.*

## Interview: Peter Ort Continued from page 11

> "There's no upside for investors on the operations of a fund. Poor operations only have downside."

capital structure arbitrage and other corporate credit-related hedge fund strategies, it's appropriate to think about them along the "passive/active spectrum" of corporate fixed income, which includes investment grade and high yield.

Investors need to evaluate these investment possibilities with their eyes open and understand two things: first, that hopefully they'll be capturing some alpha, but second, they'll be getting some beta from that hedge fund return stream. If they do this, I think people will be less disappointed with years like 2008 when strategies like equity long/short and distressed experienced losses. Why? Because those strategies are typically "net long" to their relevant markets.

**FOCUS:** *It sounds as if you're encouraging the idea of looking at things with a fresh perspective.*

**PO:** Yes, or simply understand what you're buying. You're not just buying some magic silver bullet that protects against all downsides. No one should be so naïve as to think that hedge fund managers have some sort of elixir that allows them to extract only alpha. By investing in these various asset classes you're definitely getting some beta along the way. Some managers do an excellent job of managing the risk associated with that beta. A number of managers have been able to, even in years like 2008, just deliver alpha without any beta. But a key lesson is this: across the broader hedge fund universe, it's important to recognize that it comes with an alpha/beta mix.

**FOCUS:** *How would you then expect the next 6 to 12 months to unfold? Is it your opinion that we're slowly emerging from the morass and getting back to some kind of new normal?*

**PO:** Clearly, a year ago we were standing at the edge of a cliff about to drop off into some kind of financial Armageddon. That scenario, happily, is behind us. Credit, equity, and other markets have recovered substantially in the last 12 months. As a result, it's easy to feel much better about the world. On the other hand, there are many things that still cause concern as you look out into the future. Among them: the extremely high unemployment rates in the U.S., the massive fiscal deficit, the incredible amount of monetary stimulus that has been thrown at the system. No one's really sure what the consequences of all those things will be. Certainly, there's been the beneficial effect of pulling markets back from the precipice. On the other hand, many experts are pounding the table that these actions will ultimately generate tremendous inflationary pressures. Yet there are others who believe that all the de-leveraging that's happening in the economy is inherently deflationary. So there remain a number of ongoing crosscurrents that, as always, make the markets very interesting and potentially treacherous.

> "No one should be so naïve as to think that hedge fund managers have some sort of elixir that allows them to extract only alpha."

**FOCUS:** *Do you anticipate market volatility will likely stay high?*

**PO:** Volatility is one of those things where if you predict that it will go up at some point you'll always be proven right. On the other hand if you predict that it's going to stay flat or continuously decline eventually you'll be proven wrong. As a result, I hesitate to make predictions on it because the world is inherently a place where you're going to experience volatility spikes as unanticipated events and uncertainties periodically come to the fore. So I wouldn't go out on a limb and predict subdued volatility.

**FOCUS:** *Noted. We talked about the likelihood of regulatory pressures intensifying in the coming year. Do you have other thoughts on how the regulatory climate is likely to affect the hedge fund community near-term?*

**PO:** It's clear as we emerge from the financial crisis that there will be many new regulations for all participants in the financial markets: banks, broker-dealers, hedge funds, private equity. No matter what kind of participant, there will be new governance and regulation to contend with. In many cases, I suspect the regulations will be healthy and good. They'll be predicated on lessons learned from this crisis and a genuine, well-intentioned interest to make sure that some of these things don't happen again. It's inevitable, though, that some of the proposed regulations will go a bit too far.

As relates to hedge funds, it's almost certain that hedge funds will be forced to register with the SEC. It's likely that hedge funds will also have to deal with other guidelines, such as the centralized clearing of certain over-the-counter derivatives, which could impact many hedge fund strategies. For example, how credit default swaps are ultimately dealt with will obviously affect many credit-related strategies. The OTC derivative regulations will affect trading across many asset classes: credit, foreign exchange, interest rates, and commodities.

> "The industry shows itself to be Darwinian, yet very entrepreneurial."

**FOCUS:** *And likely could raise the cost of entry. Many believe that the hedge fund community, going forward, will consist chiefly of larger firms, either on their own or through consolidation. Is that a scenario that you would think realistic?*

**PO:** It's been the trend for many years that the start-up costs for a hedge fund have steadily increased. That's not only due to increased regulation but to the competition for talent and, as we spoke earlier, the need to have world-class operations and back office. All those factors contribute to higher start-up costs. That's a trend that has been in place and will definitely continue as we emerge from this crisis. On the other hand, the hedge fund industry is a very Darwinian one. You've had many, many cycles going back 20-30 years where, after a period of difficulty, many managers elect to close their funds. But then, as we've already seen in 2009, the start-up environment for new hedge funds improves dramatically. So, new managers come to the fore. They leave other hedge funds or prop desks and strike out on their own. The industry is both Darwinian yet entrepreneurial. However, owing to the higher start-up costs now in place, there's a growing trend of new managers coming out with a strategic partner, whether it's a seed investor or a bigger, established platform that helps them get critical mass, both in terms of assets and hiring a team. That trend will continue as well.

* * *

*Peter Ort is a managing partner at Karsch Capital Management, a $3.3 billion global long/short equity hedge fund adviser based in New York City. Peter can be reached at: peter@karschcapital.com.*

## Notable & Quotable

"When you use old medicines in unprecedented dosages - and even invent some new medicines as we had to do last fall - there are side effects and after-effects. And probably they're somewhat proportional in certain ways to the extreme nature of the dosages. So you know we cannot keep running fiscal deficits like we are currently without having a lot of consequences over time."

*– Warren Buffett, Chairman/CEO of Berkshire Hathaway on the $1.4 trillion U.S. budget deficit in 2009*

"We had a lot of the signs of a 'plain vanilla' deep financial crisis. Soaring housing prices, soaring stock prices, all fueled by borrowing, especially borrowing from foreigners. All the red lights were blinking. But people were saying, "No, it's OK. Our central bank is great. We have financial globalization. Everybody loves the United States." We might not have avoided a crisis, but we didn't have to have a 'once in 50 years' event. At the time, the government didn't want any kind of recession. But it's a little bit like having a boiler where you take the release valve away and don't let off any steam. Eventually it blows up."

*– Kenneth Rogoff, Professor of Economics at Harvard University and author of "This Time It's Different: Eight Centuries of Financial Folly"*

## Interview: Craig S. Hurwitz Continued from page 13

accomplish this by reallocating money from traditional asset classes to alternatives. Instead, these groups look to take a slower route: to the extent that they experience growth in their core investments, either via fund raising or market appreciation, they'll leave traditional equities and fixed income allocations flat and commit new monies to alternatives. For college endowments, this is one way you're going to see a continuation of the proliferation of alternatives. Alternative investments are also moving downstream in the endowment market. There was a time in which only the $25 billion and up endowments utilized hedge funds. Slowly but surely, alternatives are finding themselves in the mix for endowments in the $1 billion realm. What we're starting to see now are some of the smaller not-for-profits (in the half billion to $1 billion) beginning to hire their own internal chief investment officers with the intention of increasing the allocation to alternatives.

**FOCUS:** *So the recent market struggles haven't diminished the desire to explore and commit endowment monies to alternatives?*

**CH:** Not at all. In fact, one of my theses for this "new normal" is that the wind is going to be at the backs of the survivors in the hedge fund industry.

**FOCUS:** *Is that simply because those remaining funds will be fewer in number, with more to be gotten?*

**CH:** It's actually more than that. In tough, sideways markets, the less constrained manager has the advantage. Hedge Fund managers, by definition, are less constrained than long-only managers. In a world where time honored theories, such as style boxes, come under greater scrutiny and challenge, there will be a great transformation from traditional investments to alternatives.

**FOCUS:** *How might you imagine the pie to be divided two or three years from now in terms of alternative investments' share of endowments total allocations?*

**CH:** You know I don't believe that two to three years is probably enough time to view this transformation and aggregate it. I don't believe it's going to be a quick process, as it was in the last decade. I do think, though, that if one looks at the endowments sector 10-15 years from now, you'll see that the amount of money that is managed untraditionally (that is, in some sort of alternative investment asset class) will be a preponderance rather than a small proportion.

**FOCUS:** *And that includes the likelihood of intensified regulation near-term?*

**CH:** Well, while I'm not the type of market participant who believes that more regulation is better, however, to the extent we see greater transparencies within this sector, I can't help but think it's only going to help.

**FOCUS:** *That's an interesting observation. Investors these days seem to express greater interest in transparency and liquidity than on returns. They say, "I want to make sure my investments are housed safely and securely" or, conversely, "I don't want to get a surprise phone call that my assets have been imperiled." Each of these stated beliefs, by the way, seem to trump their ambitions of higher returns. Do you see that as well?*

**CH:** I don't think there's any question that people see that. Our industry, like the rest of the economy, saw growth rates and margins that were simply unsustainable in the long run. The painful period that we've gone through is a naturally corrective process that's going to align the interests of investors with those who manage the money in a way that's going to permit the industry to grow in a much more healthy and sustainable way.

**FOCUS:** *Any final observations, Craig?*

**CH:** I hope the tenor of my message – that we're in for a tough patch – doesn't overpower my core optimism. In the long run, I'm very bullish on the American economy and our ability to work ourselves into a more prosperous place. I'm realistic, though: the dislocations affecting our economy built up over a relatively long period of time. The negative turn was swift and dramatic. However, it's amazing how quickly we've gone from abject fear to complacency and the re-embrace of risk. It begs the question as to whether any of the important lessons were really learned. I'm not clairvoyant enough to know precisely when the turnaround will begin in earnest. But when the market changes, I think we're going to experience a marvelous and sustained bull market.

* * *

*Craig S. Hurwitz, CFA, is founder and managing principal of Portus Advisors, an independent financial and consulting firm based in Cincinnati, OH. Mr. Hurwitz can be reached at craig@portusadvisors.com.*

# Horizon News

## Congratulations

Horizon is delighted to announce that **Jennifer Wenthen** has been promoted to Chief Financial Officer. With this recently-conferred title, Jennifer now oversees all of the firm's accounting practices – including tax and audit functions – and directs the company's financial strategy, planning and forecasts. She also joins Horizon's management team. With more than 20 years of accounting and financial experience, Jennifer brings – if you'll pardon the pun – a "wealth" of expertise to this important responsibility.

## Whereabouts

If you've been in New York City in the past calendar quarter, chances are you've seen Horizon's Director of Sales, **Taylor Nigro**, at one or more industry events. Over the past few months Taylor:

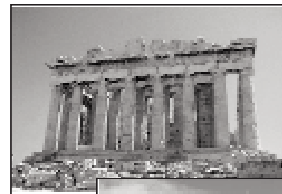
- co-hosted a hedge fund networking event at the stylish Nikki Beach Midtown. The after-work event, which attracted more than 200 fund managers, administrators and investors, was such a rousing success that Taylor promises he'll sponsor another in early 2010.

- attended HedgeWorld's Fund Services Conference. Among the themes discussed: compliance trends in the post-Madoff world, and risk management protocols that will guide economic recovery.

- represented Horizon at the MFA's inaugural "Outlook" event, a hedge fund leadership conference that attracted over 175 delegates.

## Personal Travels

**Jill King**, VP and Senior Portfolio Manager, enjoyed a sun-splashed 14-day Mediterranean cruise earlier this fall. The trip – organized by her dad and including 8 family members – commenced in Barcelona with stops in in Nice, Civitavecchia (the port of Rome), Naples, Venice and Athens. In addition to seeing such sights as the Roman Forum, St. Mark's Square in Venice and the Sagrada Familia (a masterpiece, yet unfinished, by the famed architect, Antoni Gaudi) in Barcelona, Jill was in Athens the weekend that wildfires burned deep into the night in the hills just above the Acropolis. While acknowledging that the entire trip was "magical", Jill admits that she holds a very special place in her heart for Barcelona.



## Happy Holidays

All of us at Horizon Cash Management express our warmest holiday wishes to you and to your families. Here's to a happy, healthy and prosperous 2010!

## Conference Calendar

**Look for Horizon Cash Management at these upcoming industry events.**

GAIM USA: Jan. 19-21
Boca Raton Resort & Club
*Boca Raton, FL*

MFA Network: Jan. 31-Feb. 2
The Ritz-Carlton
*Key Biscayne, FL*

## Contributors Welcome

FOCUS invites its readers to submit articles and essays for publication. If you have an idea you'd like to explore in print, please contact Brian Hurley via email (brian.hurley@horizoncash.com) or phone (312) 335.8500.

**FOCUS, the newsletter of Horizon Cash Management, is published quarterly.**

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