Talking Hedge 2006

Leading hedge fund protagonists from across UBS's Investment Bank, Global Asset Management and Wealth Management businesses talk about the fast-evolving hedge fund arena, trends and opportunities

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Foreword

Andrew Dabinett

Diarmid Ogilvy

Welcome to our Global Hedge Fund Conference – Europe 2006. This three-day event in Monaco is the second of four conferences hosted by UBS Prime Services. The first took place in Ponte Vedra, Florida, in March this year, the third will be held in Singapore in September and the fourth, also in September, will be in Melbourne, Australia. All four occasions feature leading hedge fund managers from around the world, who manage funds with a wide range of strategies. We are delighted to be hosting these events and look forward to engaging with you in what promises to be an enlightening and stimulating few days.

These conferences represent important milestones in the development of the UBS prime broking business. To mark them, we wanted to publish a document, which would serve as a 'road map' to UBS, to help participants in the fast-growing hedge fund industry navigate the breadth and depth of expertise that exists within our firm.

We believe that UBS differentiates itself in the hedge fund arena – quite simply because we touch the industry in so many ways: we service hedge funds, we manage them and we invest in them. Given this unique vantage point, we felt it would be valuable for leading hedge fund protagonists from across UBS's Investment Bank, Global Asset Management and Wealth Management businesses to talk about how they perceive the evolution of the industry and how trends and opportunities pertain to the development of their products and services. This publication, Talking Hedge 2006, fulfils this aim and comprises a collection of interviews with some of the key leaders in these business groups.

But why should such a cross-divisional document be borne out of the prime broking business? The answer to this lies in the evolution of the prime broking business itself. We believe that to be a leading prime broker over the next five years, we have to deliver more than a first class independent prime brokerage offering. We have to 'deliver the firm' to hedge fund managers – that is, the full scope and scale of UBS's global resources. The hedge fund client segment is one of our most sophisticated client groups, and as you can see from the chart on the following pages, its requirements stretch far beyond the services offered purely by prime broking. Which is why Huw Jenkins, Chairman and CEO of the Investment Bank, believes that Prime Services "sells the rest of the firm." Or as Alex Ehrlich, Global Head of Prime Services, puts it "Prime Brokerage is the part of UBS that glues client and hedge fund relationships to other parts of the firm."

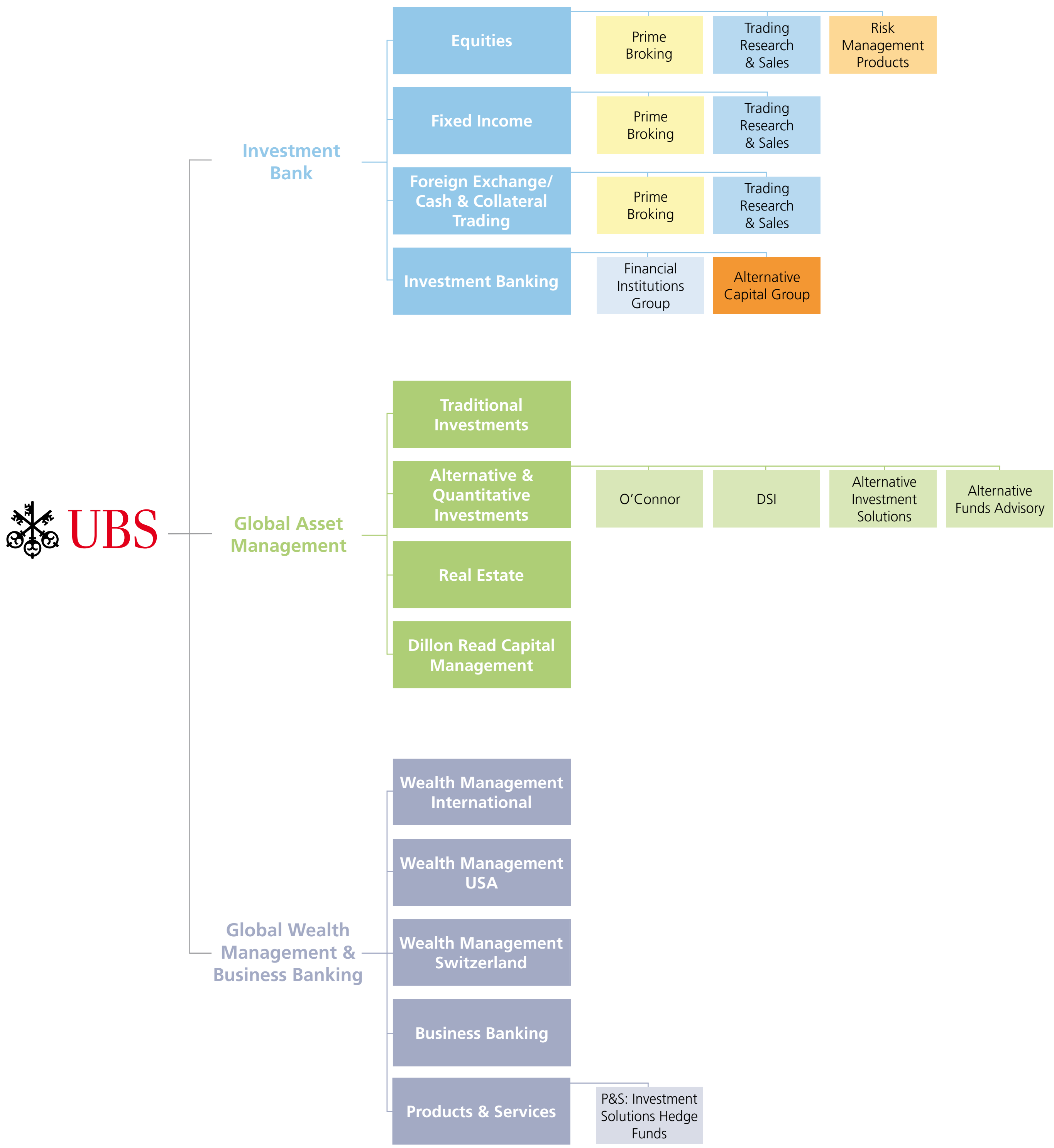
We hope you enjoy the insights offered by the participants featured in this publication and that it enables you to become better acquainted with UBS's thoughts on the industry and the extent of our capabilities. If there is a particular area that interests you, please do not hesitate to contact the individual concerned or consult the wider list of contacts within the firm that you will find listed on page 52.

Andrew Dabinett
Head of Global Capital Introduction,
Prime Services, Investment Bank

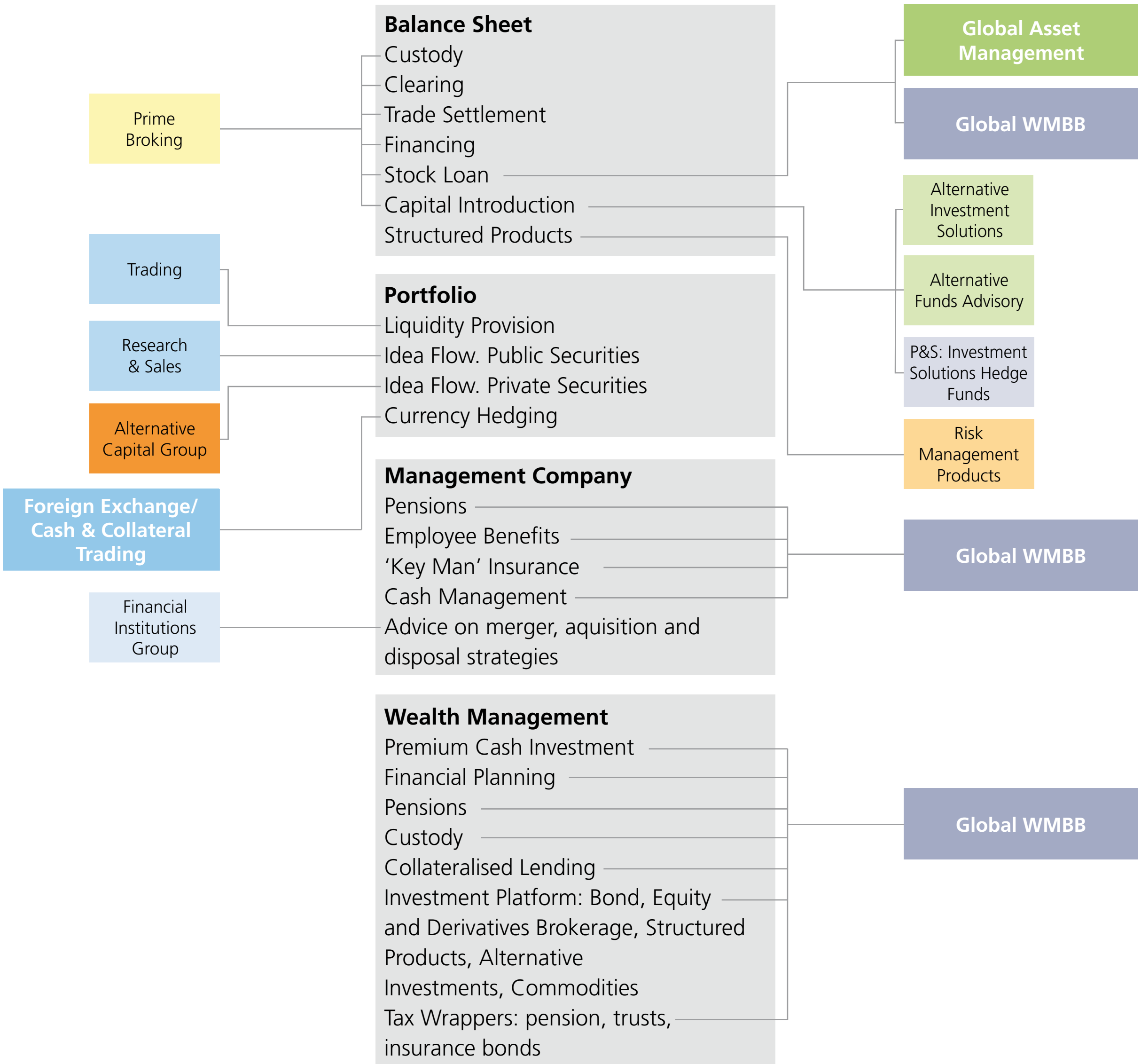
Diarmid Ogilvy
Global Capital Introduction,
Prime Services, Investment Bank

Delivering UBS, a global client-focused institution meeting all the requirements of a hedge fund manager

UBS Organizational Structure



Hedge Fund Manager Requirements



Hedge funds and UBS – "...a virtuous circle"

Huw Jenkins

Growth in the hedge fund industry is continuing apace. New funds are starting in Europe and Asia at record rates, and worldwide, managers are playing an increasingly active role in capital markets – dominating daily trading volumes and often taking activist shareholder positions that are provoking corporate CEOs to take notice of this important investor base. By any measure, this sustained growth reflects a real demand for a different type of investment – a demand that Huw Jenkins, former Global Head of Equities and now Chairman and CEO of the Investment Bank, envisaged some years ago, and whose vision contributed to UBS becoming the champion of hedge funds that it is today.

Hedge funds have become an important driver of the Investment Bank's growth and integral to its strategy. Jenkins recalls a meeting of the UBS Group Managing Board attended by senior leaders from across the firm: asked to identify opportunities where they could collaborate across business groups and what would provide the best opportunities for them to work together, he remembers saying 'if you want to choose a client base that is perfect for UBS, it is hedge funds; because we are the biggest investor in hedge funds, we're the world's largest equities trader, with a double A credit rating we're one of the most competitive providers of finance to hedge funds, we have a great capital markets practice and we've got a lot of proprietary deal flow we can offer them. We are everywhere and they want to be everywhere. We're made for each other.'

Hedge funds and UBS together, he says "is a virtuous circle. There is much that hedge funds want from a financial institution and a variety of characteristics UBS wants from clients – you get it all in a hedge fund."

Hedge funds clearly represent an important client segment for the Investment Bank. Asked about the motivations behind the growth in demand from this, one of their "most sophisticated client groups" Jenkins says "if you look at the kind of detail and rigour that goes into setting up a hedge fund business and who to use as your principal financing, operating and strategic partner, there's a huge amount of judgement and caution that goes into that decision. Of course people want an attractive operating environment and a robust and rigorous infrastructure, but what they're really looking for is a relationship. By choosing UBS as their prime broker they are choosing a partner in whom they have confidence and a firm that is highly regarded in the industry – people are invariably defined by the company they keep."

New prime broking mandates in this segment indicate that hedge funds are very happy to choose UBS as their prime partner, and UBS certainly considers itself to be 'in good company'. Jenkins recognised three years ago that the Investment Bank had to be in the start-up business in order to succeed and was aggressive in making sure that the firm took the necessary steps to make progress in the US where it is now doing very well – thanks in large part to the acquisitions of PaineWebber and the prime brokerage operations of ABN Amro. In Europe, the prime brokerage business has increased by 30 percent a year to-date. "I am very encouraged that the entire firm now recognizes that if we do not win in this area, the Investment Bank as a whole will not grow the way we should if we want to be a growth company." In global terms, Jenkins considers UBS to be the most credible of aspirants for the top three position in prime broking after the market leaders.

Assuming that growth continues, how else will UBS differentiate itself in the competitive landscape as the investment banking business faces an increasing level of commoditization, such as more emphasis on electronic trading via direct market access (DMA) or the trend towards unbundling research costs from trading and sales? Jenkins sees opportunities in each manifestation of change. "There are a couple of strategies out there – one where firms are becoming more like a hedge fund themselves – a risky strategy to all but the most robust of businesses. Then there's our approach, which is equally differentiated but goes in the other direction. What we want is to be is the intermediary of choice. Let's look at FX and equities, for example, a lot of people don't consider these attractive businesses to be in, but we do. Providing we can achieve scale and some economies of scale we will continue to extract attractive returns out of commoditizing businesses. They certainly don't offer the margin that some other businesses do, but because they have scale they offer opportunity." Jenkins is clear about the implications of this strategy in the context of prime services: "If you want to build a truly competitive prime brokerage platform you cannot do so without being a huge liquidity provider. UBS has the scale to be that provider – our franchises in equities and FX demonstrate this."

> "If you want to build a truly competitive prime brokerage platform you cannot do so without being a huge liquidity provider. UBS has the scale to be that provider – our franchises in equities and FX demonstrate this"

Jenkins has often said that prime brokerage sells the rest of the business and has talked at length about the firm's client-centric approach. As hedge funds seek an increasingly integrated service from their prime brokers, what is UBS doing to 'deliver the firm' and what does he mean by client-centric? "What I mean is that if there's a two-way bet, you should break the tie in favour of doing business with a client. As organizations such as ours become bigger and more influential they become more cautious. We clearly should not do anything that is irresponsible or that offers inadequate returns for our shareholders or capital investors, but if you can say, 'all things being equal, I am going to do business with this client rather than not do business', I think we should aim to do so, as far as possible."

Jenkins and his colleagues across the Investment Bank and from Global Wealth Management & Business Banking and Global Asset Management are focused on a highly collaborative strategy. "The exciting opportunity afforded by hedge funds", says Jenkins, "is that they invite you to deliver the firm in a way that other client segments have not. In the old days, clients tended to be single-product focused. A corporate treasurer might only be interested in talking about medium-term debt funding or an emerging market specialist at an investment management firm might only want to talk about Taiwan. Today, hedge fund managers are interested in commodities, FX, equities, emerging markets, funding rates – they're interested in access to our technology, they want to talk to our investment bankers, they want access to our Wealth Management platform and might even suggest they sell themselves eventually to our asset management business… and so it goes on. We need to leverage the entire organization on their behalf."

> 'You and us'…"it's about making the whole business available to our clients"

Delivering 'the entire organization' to the client is summed up by the firm's strapline 'you and us'. "It's about making the whole business available to our clients," says Jenkins. "It's about putting the client first – breaking those ties in favour of doing business and making sure that we respond to what a client needs from any particular part of the organization. There is a great deal of openness and interplay between our business groups and hedge funds have played a large part in making that happen."

Jenkins says he sees opportunities to share knowledge and open doors across the organization every day and is an active facilitator. Within a competitive framework, this can only be of benefit to hedge funds. So, why should hedge funds choose UBS? "What is different about us?

> "Why should hedge funds choose UBS? The simple answer is we reach more wealthy individuals on this planet than any other organization, bar none"

The simple answer is we reach more wealthy individuals on this planet than any other organization, bar none." Other factors count too, of course, says Jenkins – client service, capital provision, market presence, first-class execution, deep liquidity... "let's assume that's all flat and even between us and a couple of other leading securities companies. What is clearly not flat and even is the kind of reach that we have globally into affluent investors."

"We make clear to hedge fund managers and investors alike that UBS is very committed to this style of investment and we firmly believe that we can offer a differentiated position to both groups. The scale of our commitment says a lot about this. We are now one of the most competitive prime brokers, a highly competitive manager of funds of funds, a highly competitive provider of structured wrap products around hedge funds and funds of funds and committed to growing out into the single manager space over time. There is a huge amount of demand from all of our clients for products and services with regard to this asset class. So if you were thinking about where to go to understand, invest in or manage hedge assets, why would you not go to UBS?"

Huw Jenkins
Chairman & CEO, Investment Bank
Huw Jenkins joined UBS in 1996 as Head of Asian Equities. In 2000 he was appointed Head of Equities for the Americas and went on to become Global Head of Equities in 2004. In 2005 Huw became CEO of UBS Investment Bank and a member of the UBS Group Executive Board. Prior to UBS, Huw was Head of Asian Equities at BZW (Barclays PLC). He is a graduate of Liverpool University and gained an MBA from the London Business School.

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"...not just a prime broker, a prime partner"

Alex Ehrlich

It is now over three years since UBS completed a strategic review that identified the prime brokerage business as one of the most critical gaps in the Investment Bank's portfolio of hedge fund services. Alex Ehrlich arrived at UBS in May 2003, intent on challenging Goldman Sachs and Morgan Stanley for the global lead in prime brokerage. Backed by the firm's senior management, a significant investment in talent and a world-class technology platform, Ehrlich and the team were united in their determination to develop a 'best of breed' business. Here, Ehrlich offers his insight into how UBS is attempting to turn the 'duopoly' in prime brokerage into a new oligopoly, and describes how he wants to deliver to hedge fund clients the full strength and depth of the firm's global capabilities – as prime broker and prime partner.

> "Prime brokerage at UBS reflects much of the Investment Bank's 'bigger picture' strategic goals and the 'you and us' proposition at the heart of the firm"

Prime brokerage at UBS reflects much of the Investment Bank's 'bigger picture' strategic goals and the 'you and us' proposition at the heart of the firm. This, says Ehrlich, is what attracted him to UBS. "As soon as I started talking to UBS it became very clear to me that the firm was truly serious about being the best in the business. The senior management team had already exhaustively analysed what it was going to take to build a world-class prime services offering. It understood that it would necessitate a long-term plan of three to five years, require hiring hundreds of people, spending hundreds of millions of dollars on technology, and delivering an integrated product that would be wholly integrated with the rest of the franchise."

What particularly intrigued him was the idea that UBS did not just want to be a leading prime broker but a leading player in the hedge fund client segment. It was this loftier goal that would cement UBS's position as one of the world's leading global investment banks. "Here was one of the world's great financial services franchises with a clearly differentiated strategy at group level, which has the best credit rating of any competitor in the industry, a very substantial balance sheet, a tremendously powerful equity franchise globally and which understood the strategic inter-relationship of prime services and the importance of delivering the wider firm to hedge funds. It was very exciting," he says.

Strategy

The investment bank's strategy, he explains, has much to do with understanding the macro changes that have taken place over the last few years in the investment banking business. Among these trends: revenue contributions from different client segments have changed – and hedge funds have emerged as among the greatest contributors to earnings. There has been continuing commission pressure. Increased client use of direct market access (DMA), resulting in cheaper electronic execution for clients, and the unbundling of the costs of research, are two further examples of developments that have worldwide impact on how clients pay their investment banks. As Ehrlich says "if you look at the growth in the flow of assets into hedge funds, and if you look at the increasing commoditization and related cost pressures on so many parts of the traditionally most significant revenue drivers of investment banking, you start to see that UBS as a firm, with its increasingly holistic approach to clients, is running a very differentiated strategy relative to our leading competitors."

These macro trends have created an environment in which, he says, UBS Prime Services is simply trying to execute on one important leg of the overall investment banking strategy. "We want to get all of UBS's hands around these increasingly important client relationships, where there is less revenue to be developed in many of the individual silos. If you get the entire servicing model correct, you can capture more revenue in terms of overall market share and overall share of wallet. The individual fee pools are going to continue to decline. What we are trying to do is get a larger slice of these smaller fee pools from the hedge fund's activities across the whole investment bank. This is a very different approach to some of our competitors, who are often cherry picking where they want to focus their attention."

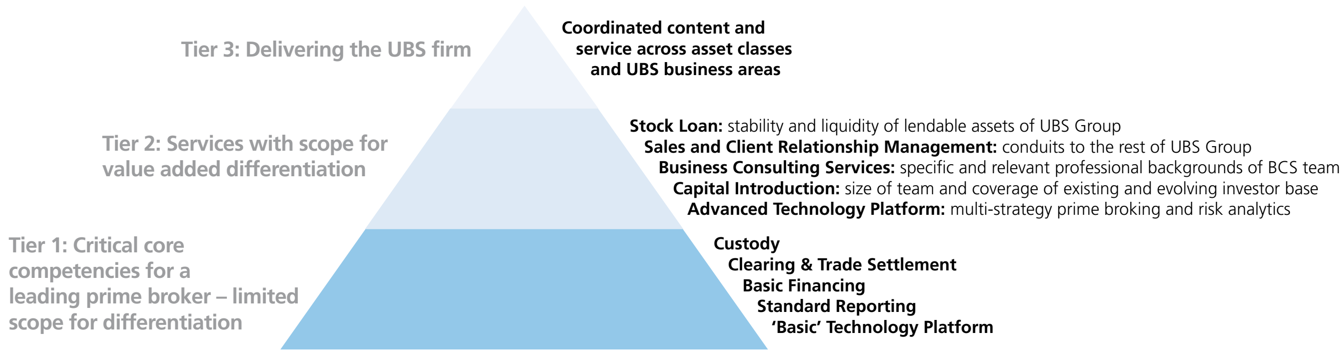
Ensuring that all areas of the investment bank and UBS as a whole work to the advantage of prime broking clients is a key challenge. "We have worked hard to ensure that the equity prime brokerage platform interacts seamlessly with all parts of the investment bank. We clearly have the wholehearted sponsorship and support of the equities division, that's where we have our historic roots, but we are equally well supported by our fixed income and foreign exchange businesses. Everything we are doing at UBS aims to pull together our product strength across all asset classes. I think this will be one of the factors that distinguishes UBS over the years to come – we want to deliver the 'holy grail of prime brokerage'; a unified platform for our clients, no matter what or where they wish to trade."

The value added pyramid

So how does Ehrlich perceive the development of the UBS prime services offering as it stands today? "Our offering has to be seen as superior. I see our product as a pyramid with three tiers. The first tier features products and services that we need to admit are pretty much commoditized. These are things that all clients want and that any competent prime broker needs to provide in order to be credible. They are the core traditional operating functions: custody, clearing and trade settlement, 'simple' financing, and a technology platform that offers hedge funds the appropriate basic reporting related to these services. And although I say that this bit of the product is commoditized, it's only a commodity to the extent that a prime broker must do these things flawlessly day in and day out. That's the standard, and if you aren't truly excellent at this piece, becoming so is a huge barrier to entry.

The second tier goes beyond the basic commoditized services and is where UBS believes it can start to differentiate itself with value-added capabilities. For example, stock loan would clearly fall into this category. Given that UBS is the world's leading wealth manager and one of the leading global asset managers,

UBS Value Added Pyramid



we believe we have a structural advantage in stock loan because we have unparalleled access to the lendable assets of the group. Sales sophistication is another important area," says Ehrlich. "Because a prime broker is so integral to a hedge fund manager's business, a sales person who can communicate effectively, interpret – even anticipate – the needs of a client, becomes an important differentiator. We view the sales process as being so critical to a new relationship that we will go to extraordinary lengths to ensure our client's vote of confidence. We find this often comes from the business consulting services that we offer. Start-up managers in particular appreciate the team's advice on a wide spectrum of issues ranging from regulation, infrastructure, tax, legal domicile, choice of service providers – right through to finding office space. We try to alleviate the pressures facing a manager launching a new business and fund. This kind of intimate and value-added involvement has helped create some of our most enduring relationships." Capital introduction is another area where a prime broker can differentiate itself," he says. "For hedge fund managers who are seeking to grow their investor capital, it's a critical differentiator. Developing the appropriate marketing strategy and facilitating introductions to the right investors can significantly enhance the probability of success for a start-up manager or the stability of an established manager's asset base. These are genuine value-added services to a hedge fund business." With 25 professionals based in New York, Chicago, San Francisco, London, Tokyo, Hong Kong and Sydney, the UBS Global Capital Introduction team is now one of the three largest on the Street. Size is critical to providing effective coverage of current investors into hedge funds and to developing relationships with the new frontier of investors.

Finally, Ehrlich notes that while 'basic' technology may be a commodity, 'advanced technology' is anything but commonplace. "While most global prime brokers can settle and report on equities, the state of the art is way beyond that. By the end of this year, we will have invested over US$200 million in our new prime brokerage technology, comprised of four entirely new platforms – global custody, risk, client interface, and finance.

We recognise that hedge funds are looking for integrated reporting and financing across asset classes. It is part of our ongoing plan to bring together the equities, foreign exchange, fixed income, and futures and options clearing platforms. We are committed to investing in a new technology framework that will fulfil our ultimate goal of providing not just portfolio margining, but also a service model across asset classes setting a new standard in the industry".

The third level of the pyramid, he says, is the ability to sell and deliver the entire investment bank. "Until a few years ago prime brokers competed on the first and second tiers, which amounted to the whole pyramid. A hedge fund would be able to study it, analyse the costs and services and pick a broker. That was the old world. Today, we have to sell the whole package and hedge funds now ask themselves 'do I want UBS as my partner or someone else?' We understand that the hedge fund industry and business model is fast-evolving and that the larger firms are now developing into diverse asset management firms with a range of products striving to generate alpha

> "It all stems from our client-centric mission to be the world's leading provider of content and added value to a client segment whose requirements are very diverse from a product standpoint and a geographic standpoint"

across the cycles. When hedge funds 'partner' with UBS they get the whole firm. It all stems from our client-centric mission to be the world's leading provider of content and added value to a client segment whose requirements are very diverse from a product and geographic standpoint."

Tangible mechanisms that 'deliver the firm'

Ehrlich points out that while all the leading prime brokers talk about 'partnering' with their clients, tangible delivery of that proposition is what counts. He is passionate about achieving this, "we're not just talking about the service ethos – we're actually putting something in place that clients can touch and feel and gives them confidence that UBS will deliver. There is complete strategic alignment across our equity, fixed income and foreign exchange businesses. The senior management of these businesses all recognise that hedge fund clients want a comprehensive, cross asset class prime brokerage product offering with a single point of contact, and we are aggressively moving to converge these businesses into one over the next few years. We believe there are only two competitors that are thinking like us in this regard."

UBS's organisational structure reflects its desire to deliver tangibly as one firm. "Our ability to represent the interests of our clients at the most senior level is institutionalized – it is embedded in the way we run our organization." For key clients, this includes tracking their P&L to highlight the value of the relationship across different products and business areas. "We regularly discuss the issues facing clients and how the investment bank as a whole can respond. Clients that are important in one area are offered a premium service across all areas regardless of whether they are important to a particular product or not. This is something new in investment banking."

It is clear that hedge funds have the ability to stretch any investment bank through their use of different products across diverse geographic regions. More than this, hedge funds typically have a minimalist organisational structure in comparison to the vast, complex organisations who serve them. How does Ehrlich view that challenge? "We need to have a conversation with a global hedge fund that in many cases is run by just two people and ensure that they understand us. We need to deliver the whole firm to those two people and deliver resources out of products where the revenues are separate. It's difficult, but that's why we have the Global Hedge Fund Committee and the people who run the hedge fund facing businesses sitting on our management committees."

Building on achievements

The December 2003 acquisition of ABN Amro's prime brokerage business has been a significant building block in the construction of UBS's prime brokerage business, effectively jump-starting its competitive positioning in the US. Asked about the progress of the integration programme Ehrlich says, "by any measure it has been very successful. The growth rate of that client base has been strong, client retention has been nearly 100%, and the people have taken up key roles across our organization." Overall, the acquisition gave UBS an experienced sales force and a credible platform that is going from strength to strength. Looking at the league tables, this appears to be paying dividends. In the US market, UBS ranked third in 2005 for winning nine sole prime brokerage mandates for funds that were greater than US$50m[1]. Not far behind Morgan Stanley, or the 11 won by Goldman Sachs and well ahead of the rest of the competitors. In 2003 the number of sole prime brokerage mandates won in the US by UBS for funds more than US$50 million was zero.

Regional growth

Looking at other regions, UBS has stolen a march on the competition in Asia achieving industry recognition as an innovative provider. In the recent survey, UBS achieved the top position in three of the four categories that *Asiamoney* polled hedge funds: Most Innovative Prime Brokerage Firm, Best Pricing and Best Client Service. "We are particularly excited" says Ehrlich, "about the prospects in the non-Japan Asia market, where progress has been, and will continue to be, faster than anywhere else. In non-Japan Asia, competitors do not have the same entrenched position that they do in the US, Europe or Japan. And of course we already dominate Australia in terms of market share, where we have leveraged the very strong equities and banking franchise that UBS enjoys down under."

In Europe, UBS is a clear third, according to a recent survey by *EuroHedge*. In 2005, UBS won 46 sole mandates [2], not far behind Morgan Stanley and Goldman Sachs and double the level of sole mandates won by the fourth ranked prime broker. "Unsurprisingly, we are delighted with progress and exactly where we hoped to be by this time," says Ehrlich.

But, he says, what really matters is the quality of product. Accolades and awards are clearly not always a true measure of achievement. "There are some positions you track that, for me are important, but which are less public. One that's really important is something we call 'net new money' – the net balances moving into UBS, excluding start-ups. In 2005, our net new money was positive by a balance that we think represents about 1% of the global market. It's an interesting measure of our competitiveness and implies that we moved a significant portion of the global market from other prime brokers to UBS. In 2006, I would like to see twice that much." Ehrlich goes onto explain that UBS has attracted a number of exciting high profile clients, where it has been engaged as lead prime broker or appointed as second and third prime broker. "This is, of course, very important. Our people, are extremely service oriented and have worked hard to win these clients' trust. It is good to see that through the course of 2005 we have witnessed a virtuous circle developing as current and new clients, particularly the well-established large hedge funds, give positive referrals of our product and service capabilities."

The future

Ehrlich is enthusiastic about the opportunities to build on these accomplishments in the years ahead although his enthusiasm is tempered by a pragmatic determination to ensure that he and his team do not 'over promise and under deliver'. "We've been growing the business at a phenomenal rate – more than three times the size we were three years ago. We need to make sure that our investments in people and technology keep up with our growth rate. I spend an important proportion of my time making key hires and ensuring that we deliver to our clients the large investments that we have made in technology. In many respects, we've just laid the foundations. While we are starting to reap the benefits, I expect huge advances to be made over the course of 2006 and 2007."

And the competitive landscape? How does Ehrlich see it developing over the next five years? "That", he says "is going to have to change so we are first among equals." Importantly, he envisages a polarisation amongst prime brokers. "Five years down the road, I think you will probably have two types of prime brokers. The kind that we want to be, which is a global, cross-product, cross-asset class, highly integrated prime brokerage business, which looks less like an independent prime brokerage business and more like it is the part of the firm that glues client and hedge fund relationships to other parts of the firm. The other type of prime broker will be the niche providers who have not been able to execute on that strategy, but who bring some unbundled value to the table. The first category should include firms like UBS, Morgan Stanley, and Goldman Sachs. These three clearly have a global ambition, a global footprint and global execution capability. But I think it is going to be very hard to be anything other than a niche provider if you are not successful as a global investment bank and successful in executing in global prime brokerage across asset classes and strategy. And that assumes that you've got a good credit rating and can fund yourself efficiently, because big global banks with strong credit ratings and balance sheets have fundamental financing advantages."

Ehrlich reiterates the importance of people and strong relationships in the prime brokerage business. Soon after joining, he felt reassured that the firm had the "stomach, credit rating and global franchise" to execute the prime services strategy, but Ehrlich also found "a much warmer relationship" between clients and UBS. "That really gave me confidence that we could build something that was world-class, that would not be second-tier relative to the market leaders – I found that the most amazing customers in the world were friends with UBS and wanted to work with us. We are working hard to make sure that the prime brokerage offering matches the excellence found in other areas of the firm."

[1] Absolute Return Magazine - March 2006 edition

US prime brokerage: mandates for new funds - 2005*

Firm	*Sole*	*Shared*	*Total*
Morgan Stanley	16	16	32
Goldman Sachs	11	21	32
UBS	9	4	13
Bear Stearns	5	12	17
Deutsche Bank	2	7	9

* New funds of over US$50m where prime brokers could be confirmed

[2] EuroHedge Magazine - February 2006 edition

European prime brokerage: mandates for new funds – 2005

Firm	*Sole*	*Shared*	*Total*
Morgan Stanley	58	23	81
Goldman Sachs	54	23	77
UBS	46	7	53
Credit Suisse	23	8	31
Deutsche Bank	15	14	29

Alex Ehrlich
Global Head of Prime Services, Investment Bank

As Global Head of Prime Services, based in New York, Alex Ehrlich is responsible for directing UBS's Prime Brokerage and Exchange Traded Derivatives businesses around the world. He is a member of the Investment Bank Board, the Investment Bank's Global Hedge Fund Committee and Equities Management Committee. Alex joined UBS in May 2003, following 24 years at Goldman Sachs where his most recent roles included global head of securities lending and global co-head of prime brokerage.

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FX and hedge funds – a holistic approach

How do you sustain a world-class service that offers incremental value to hedge funds in 2006 and beyond? Ellen Schubert, head of hedge fund relationships for Foreign Exchange and Fixed Income talks about the development of a holistic approach to the foreign exchange needs of hedge fund clients and the drive towards becoming a full-service, top-tier provider to hedge funds across all strategies.

Ellen Schubert

UBS has a leading franchise in Foreign Exchange as a result of the holistic strategy that you have engineered. Tell us about the key components of this strategy?

From 1996-2004, I ran the North American FX business. During that time we had a niche strategy concentrating on the top 100 clients in North America, with a focus on high margin derivatives product. The FX business was regionally run with only a loose confederation holding us together globally. As the need for greater coordination emerged, I was asked to construct a global strategy for the hedge fund client segment, focusing on those clients that traded in more than one time zone. I spent a lot of time talking to clients about what they were looking for from their banks, what was missing from the way their banks were currently covering them and what products and services they wanted from external providers. The information we gathered enabled us to broaden our product set in ways our competition had not considered. It was at this time that the leadership of

“Through our significant investment in technology we made it easier for clients to deal with UBS – this strategy took us to the forefront of the evolution of the FX business”

UBS made it a stated goal to be a top three player in global investment banking. By definition, if you are going to be a top three global investment bank, you have to be a top three player in the largest and deepest market – namely FX. As a result, in 2000/2001 we had to change strategy completely from being a niche player with an emphasis on FX derivatives to a wholesale provider of FX products and services.

The only way we could become big in FX was by investing in technology that would allow us to access more clients without adding more people. So in 2001 we invested heavily in our electronic trading infrastructure and began thinking about entering the prime brokerage business. We had to make it easier for clients to deal with UBS and easier for UBS to process trades without adding more overhead. This strategy took us to the forefront of the evolution of the FX business – from being a manual, ticket-based business to one with a fully reengineered front to back process allowing for electronic processing … from execution to confirmation. Most of our business now is done this way, without any manual intervention.

UBS was late into the prime broking business, what did you ‘bring to the table’ that was new?

Yes, we were definitely a late entrant into FX Prime Brokerage, so we knew we had to provide a better service in order to attract clients to our product. This was early 2001, the same time we began deploying our electronic trading technology. Industry practice in prime broking, like execution, was very manual. The incumbent FX prime brokers were underinvested in technology because they had already made huge investments in people. Unfortunately a reliance on manual processing means the business cannot be expanded without increasing processing capacity and hence, variable costs. Our goal was not only to get into the prime broking business, but to do so with electronic solutions for processes such as give-ups and trade matching that were extremely scaleable. When we began marketing our product in late 2001 our fully electronic approach differentiated UBS. Our new prime brokerage service was seen as a natural complement to what we were doing with our trading tools and UBS FX quickly became the recognized leader in electronic trading and trade processing. Between 2001 and 2004, UBS was the FX technology pacesetter for hedge funds, but just because we were the recognized leader, did not make us the leader in terms of number of mandates or volumes processed. In prime brokerage – and this is true for equities and fixed income prime brokerage – once a hedge fund manager has chosen a prime broker, you become part of their operation; in most cases, it is a very ‘sticky’ proposition. It took a few years to close the gap between ourselves and the top prime brokers, in terms of number of mandates. In the beginning, we were winning perhaps one in eight pitches; now, we win almost one in two. It varies by region, but typically we are competing against a field of 10-15 prime brokers.

But I don’t want to give the impression that it is merely the investment in technology that has lead to our success. We believe that prime brokerage is still very much a relationship business. Our relationships and client services are a distinguishing factor for UBS. Quite simply, the quality of service that you provide to your clients becomes a critical part of your pitch to win your next mandate. If your current clients say they love the service, that they have a strong relationship with the service team, that their problems are resolved quickly and efficiently, and that UBS is truly close to their operations, it really is much easier to win the next mandate. Consequently, we consider our client facing operational staff as sales people – sales people who happen to have an operations background. Everyday, they represent UBS to our prime brokerage clients. They are the people who are most important to the sale of our prime brokerage offering.

Tell us how you see the future of FX prime brokerage?
The future will be an integrated service with the other asset classes. Many of the FX-only hedge funds already prime broke with us. The real opportunities for us going forward are the big global, multi-strategy hedge funds that want to have one, or a few, prime brokers that can service them across asset classes. This is why we have invested so heavily over the last three years in our equity prime brokerage product and why we are now investing heavily in our fixed income prime brokerage offering. The future is the convergence of all the various groups.

What other opportunities do you see to service hedge fund managers?
Other than the hedge funds who trade foreign exchange as an asset class, there is also an opportunity to capture transactional business with funds that need to settle cross border security trades, translate dividends, or hedge a portfolio of international securities. Some of the major currencies have seen huge swings over the last five years and failure to hedge would mean these swings become an important component of a manager's returns, either positively or negatively.

So now we are focused on providing technology that allows them to easily hedge their FX risk associated with international securities. We are working with the equity technology group, the direct market access (DMA) group, and the equity prime services team, to enhance their product offerings in order to embed FX trading in their technology. Currently when equity long/short funds, for example, trade international securities, they either ask their prime broker to execute the FX manually as part of the security transaction, or they wait until the end of their trading day, and do all their FX then. While this may offer netting benefits it may also expose funds to a great deal of intra-day FX risk. Many hedge funds we have spoken with would prefer the required FX trade to be executed at the same time they buy or sell the security. This is particularly appealing when it all can be done electronically with one key stroke. Automating these 'induced FX' trades as much as possible is an area we are investing in.

"The future of FX prime brokerage will be an integrated service with the other asset classes"

In a similar fashion we are working with select external equity order management software providers to allow clients to electronically route FX trades to UBS, independent of whether a manager prime brokes with us in equities. Again, our purpose is to make it easy for clients to have electronic access to our FX trading services whether or not they are an equity execution or equity prime brokerage client of UBS. We would clearly prefer them to prime broke and execute their FX with UBS, but we also want to be able to source those FX trading volumes, irrespective of where their securities are custodied. Of course, we're not alone in working towards the Holy Grail of cross-asset class prime brokerage.

How do you think UBS will stay one step ahead?
I don't think anybody currently does it better than we do. Some organizations have equities and FX prime brokerage under one roof. Others have FI and FX, but no one has all three prime brokerage offerings together. UBS is actively working to converge all our prime brokerage services in the near future, but for now we are building three strong platforms and marrying the technology where it makes sense. The example above is a good one. UBS is one of the few prime brokers thinking about the induced FX piece of the equity strategies. We are trying to make our technology solution satisfy all aspects of a client's trading needs. I think everybody will do prime brokerage – everybody will have fixed income, FX and equity prime brokerage – but that does not mean that they will build superior multi asset class trading capabilities that are fully integrated with their clearing services.

Our other key edge in FX is that we are a globally-run business, which is different from most of our competition. One or two other banks run their FX hedge fund business globally, but most run them on a regional basis. Clients rank us consistently very highly for our global coordination, which is probably one of the reasons why we are ranked in the top three by hedge funds. We make it clear to clients that, if they want to pay 'Natalie' in Stamford for her great relationship, they can pay her indirectly by dealing in London and in Asia, because Natalie gets credit wherever they deal. We evaluate and compensate our sales people globally for client revenue, not on their individual revenue. We're using the corporate knowledge that we accumulate every day in our relationships with clients, and passing it on to our team mates in other regions so that our clients get the same experience center to center. This way they have an understanding of the clients' interests, how and what they trade, and what is important to them. We are currently applying this same holistic approach to our Fixed Income hedge fund business.

"What makes UBS different is the fact that we are thinking about all aspects of the hedge fund…we are trying to make our technology satisfy the client for all aspects of their trading and clearing…"

You run a pool of bank capital that is invested in FX hedge funds and a FX fund of hedge funds. How is this part of your overall FX strategy?

Yes, we run a pool of hedge fund investments, whereby we invest bank capital directly in our clients, to truly partner with them. This really differentiates UBS as a prime broker. People ask whether there is any conflict; there is none, because the decision on investing is separate from the sales function. We are investing bank capital because we believe in these funds and believe that UBS will benefit from the investment. It is also a way for us to interact with the client in a different way than purely as a prime broker. If we invest in them, we sit at the table as an investor; if you come at it from both the back and the front, you really understand your client, they understand you, and they have an interest in building a relationship that is mutually beneficial. All of this really solidifies the relationship that we have with these customers.

We have recently outsourced some of this invested capital to a prominent, external FX fund of hedge funds, for a few reasons. First, we wanted third-party due diligence. Second, we wanted to be invested with a fund of hedge funds that was making more meaningful investments than UBS FX were able to do in any particular fund. Third we wanted to diversify our risk; our selected fund manager has over 30 different investments. UBS is co-invested in 18 of these funds and we have a further four investments outside this partnership. Finally, we benefit from their investment because they have chosen UBS as their prime broker. This means that anyone they invest in, whether UBS invests or not, becomes a UBS prime brokerage client.

What are the key ingredients for success in your longer-term vision?

I chair the Global Hedge Fund Committee, whose goal is to maximize cross-asset class coordination for our most important hedge fund relationships. From that seat, I knew two years ago that the right thing to do is to merge the Foreign Exchange, Fixed Income and Equity hedge fund prime brokerage businesses. We should give our clients a common experience, ensure that they can select from a menu of one or all three products. If they choose all three, they would have one point of contact and one set of reports, and they would know that the back end is run by one team. Holistically, that is how we must approach it. The key ingredient to that longer-term vision is cooperation and coordination of strategic plans across asset classes. We have already tackled the single asset class set of hedge funds for equities and FX.

Our challenge now is to roll out a fully integrated cross asset class prime brokerage offering capable of servicing the needs of tomorrow's most demanding clients; the multi-strategy firms who invest globally across the asset spectrum. This is our future.

Ellen Schubert
Global Head of the Fixed Income and Foreign Exchange Hedge Fund Business, Investment Bank

Ellen Schubert is Global Head of the Fixed Income and Foreign Exchange Hedge Fund Business, Global Head of Prime Brokerage for FX, and Co-Head of UBS's Cross Product Hedge Fund initiative. This group is responsible for the development and implementation of the hedge fund strategy across the Investment Bank.

Ellen is a member of the UBS Investment Bank Board, a member of the Federal Reserve Board - Foreign Exchange Committee, and Co-Chair of the Operations Managers Working Group. Ellen was the recipient of the Merit Award from the Women's Bond Club of New York in 2004 and the Leadership Award 2005 from the 100 Women in Hedge Funds Association.

Ellen started her career in 1983 at the Chicago Board of Trade. In 1987 she joined the derivatives house First Chicago/O'Connor, which was acquired by Swiss Bank Corporation in 1992. Ellen received her BA in Economics and History from Miami University, Oxford Ohio (graduating cum laude).

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Alternative Capital Group – a pioneering initiative

Suzie MacCagnan

Suzie MacCagnan, Richard Royden and Craig Wadler talk about the Alternative Capital Group (ACG), the new group set up as a gateway for hedge fund clients to the Investment Bank. Craig is based in Los Angeles, covering US hedge funds, while Suzie and Richard cover European hedge funds out of London.

Richard Royden

Craig Wadler

How did the Alternative Capital Group come about?

CW The rationale for the group was that hedge funds, whether in the context of financing transactions (debt or equity) or M&A transactions (buying companies, participating in buying/selling companies or supporting/opposing acquisitions) were more influential than they have ever been. And we, as a firm – from an IBD (Investment Banking Department) perspective – did not have direct relationships with the buy side such that we could utilise them to the benefit of our corporate and financial sponsor clients. We believe that there are tremendous opportunities for financing and other deal-related revenues by having direct access to some of the more influential hedge funds.

SM What is important here is that the demand for this type of concentrated coverage on hedge funds has been universal and without any geographic boundaries. In order for UBS Investment Bank to fully address this growing need, we have built a global team that brings together the creative idea generation with the relevant transaction and structuring skill sets for both public and private opportunities. Effective coverage is all about being able to represent the hedge funds investment criteria in these situations and being able to get them involved early on in potential transactions.

Alternative Capital Group

Established in August 2005, and sitting within UBS Investment Banking Department, the Alternative Capital Group is a dedicated, growing team that provides hedge fund clients with access to a wide spectrum of contacts in IBD and deal flow, such as:

- **debt/equity co-investment opportunities**
- **corporate transactions, strategic stakes**
- **capital raising: pre-IPOs structures, PIPES, direct project equity**
- **structured equity/debt underwritings**
- **insurance/CAT bonds**
- **strategic development.**

To what degree is this a pioneering effort on the Street?

CW On Wall Street, in general, we're seeing a focus on hedge funds. However, we don't think other investment banks have figured out an organised way to cover hedge funds. I think this is in part because the revenue model is not clearly apparent and in part due to the fact that people have had their work cut out just covering their corporates and financial sponsor clients. But we (ACG) are clear about what we want to achieve in the US and globally, which is to facilitate dialogue and transactions between hedge funds and corporate clients. Our effort is a much more all-encompassing global effort from a strategic and product perspective. Furthermore, we bring to hedge fund clients a comprehensive relationship with a team that has backgrounds in M&A, equities and debt.

SM There is a 'first mover' advantage here which we feel we have been able to capitalize on. Importantly, a large part of how we cover this sector is being driven by the constant feedback that we are receiving from the hedge funds on what works and what doesn't from their point of view. Whilst respecting information barriers and client confidentiality agreements, a central theme to our coverage approach is being able to audit the investment banking opportunities as they are developing and selectively bring in the hedge funds into the equation before a potential transaction is completely structured – similar to the way we would work with a financial sponsor on a deal. Given that, in many cases, hedge funds are still in the process of building their internal corporate finance expertise on situations like public-to-privates or straight private capital deals, it is essential that we remain diligent on vetting the opportunities before we show them the deal. Hedge fund capital is extraordinarily flexible but we want to ensure that that financial flexibility isn't read as 'show them anything and everything'. The ideas and the deals must be in sync with their investment criteria.

Do you expect hedge funds to increasingly become part of the idea flow, in that they will come to you with ideas and you will open doors accordingly?

RR Yes, absolutely. It's a mark of a maturing industry, how the hedge funds are being covered and how they're searching for additional return, the incremental return. I think the most effective hedge funds that we've been dealing with are those that are getting out of the pure trading mindset and are taking a more strategic, longer-term investment approach. This kind of corporate finance approach means we're seeing hedge funds act much more like a financial sponsor. They increasingly come to us and say that they have an investment in a certain company and believe it should make an acquisition or maybe spin-off a particular asset, or that there's a trend for consolidation in a certain sector. We are able to give them the platform and conduit to close that loop.

CW The longer term view being taken by hedge funds is worth noting; it's a misconception that hedge funds are all about the short term. Hedge funds are adopting a private equity like approach to their investment philosophy. They are looking at opportunities from a credit, balance sheet and strategic perspective. Suspecting that management teams left to their own devices would not necessarily focus on creating equity value, hedge funds try to articulate to management teams how they should be approaching their balance sheet and their strategic direction, based on extensive analysis and credibility. Essentially hedge funds want to unlock value in a company and will work with management teams to do this – or of course help introduce new management teams to unlock the value. I agree with Richard that more of the idea generation comes from hedge funds. They want to be in front of our corporate clients and / or financial sponsors, in advance, to help create and shape transactions. Hedge funds today are driving deals as evidenced by the number of companies that have engaged bankers to explore strategic alternatives.

> "Effective coverage is all about being able to represent the hedge funds investment criteria in these situations and being able to get them involved early on in potential transactions"

This mindset has of course led to the increasing amount of shareholder activism we are seeing in the US and Europe. Do you think we'll see this trend continuing?

CW Yes, I think we will. The 'money' and the backgrounds of the people who are investing the capital are more sophisticated – they are also more accountable through their limited partnerships. So they have all sorts of resources available to help them find out what companies are really worth – sell-side analysts, other buy-side investors, consultants, accountants, lawyers, bankers, former industry executives. They are able to collate all this information into a thesis and to force companies to respond to their views and ideas. There's more power in the hands of shareholders today than there's ever been.

SM Activists have been spurred on by recent successes and we are going to see more of it. And of course hedge funds as a rule don't have the same conflicts that institutions have. By that I mean access to management. Typically, the lifeblood of traditional asset managers is access to the management of corporates and if you're seen to be anti-management that will impact on your ability to gain access. However,

"Corporates, particularly in the US and increasingly in Europe and Asia, are beginning to appreciate that there is a powerful and deep-pocketed pool of capital out there, which can't be ignored"

I think hedge funds can afford to be more 'hard nosed' about this and take the view that if they have a material position in a stock and they're able to create change (and if necessary do so by going public) then the hedge funds and the shareholders will benefit. I'd say that public activism is probably a last resort for any investor. Nobody likes to do it, but if management seem to be destroying value, then you really have no choice – hedge funds act in the best interests of their capital providers.

RR I would add that while the activist managers are grabbing the headlines, we're finding that a lot of other managers are being fairly aggressive in other areas and in other avenues too. From a private capital standpoint, in many cases hedge funds are seen as a very compelling alternate source of funding for a number of situations, from a straight private injection, through to some sort of structure debenture, or structured note. This is because they're not, by their very nature, looking to come in and take control positions. They are extremely fast moving, quick to react and from a corporate's point of view, they can be sources of fairly friendly capital. This contrasts with the way that a financial sponsor or other strategic related capital could be perceived and so represents a tremendous source of opportunity for the hedge funds.

That's an interesting point. Corporates' perception used to be that hedge funds were not a source of friendly capital. How is this changing?

SM That is certainly the perception that the press would like to propagate but we're finding that corporates, particularly in the US and increasingly in Europe and Asia, are beginning to appreciate that there is a powerful and deep-pocketed pool of capital out there, which can't be ignored; and of course, in many situations the hedge funds are aligning themselves with some of the larger institutional investors or the larger private equity investors and are seen as perfectly easy to work with.

RR Of course, there are perceptions and expectations to manage but this is not predatory capital, it is capital looking for a reasonable return that can be very effective in certain situations.

And what if hedge funds turned out not to be friendly capital…?

RR As an investment bank we obviously need to keep on top of our corporate clients' shareholder register. If we felt there was activity brewing that was not consistent with our clients' objectives, then ACG would advise accordingly. Having a group that focuses solely on hedge funds allows us to extract reconnaissance – we are very well informed, which means we are also well prepared and able to offer the best advice. We communicate, we understand our corporate clients and what they need and we work flat out to make sure that we deliver them the best service we can.

SM And it is in the normal course of banking business to have discussions with our corporate clients about investors or potential investors who may be building a position to stir the pot. It is our job to provide the insight and guidance as to how investors perceive situations and how they may react.

Shareholder activism, a corporate finance mindset – these seem to be partly a function of the increasingly difficult search for alpha. We are also witnessing an expansion of the duration of hedge fund managers' investment time horizons, which has meant managers are investing in increasingly illiquid positions, quasi private equity. At the same time we are seeing private equity firms and individuals setting up hedge funds. Can you give us your thoughts on this convergence between the hedge funds and private equity worlds?

SM Yes, there's a lot of convergence. Even within the wider asset management space, asset managers are saying 'this is another piece to the pie that we want to fill in'. One thing that's come across loud and clear is that the flexibility and versatility afforded by the hedge funds is very attractive. Their ability to go into all types of securities, all aspects of the capital structure, in virtually any industry and any region around the world, that flexibility is, to a certain extent, envied by the private equity world. On the other hand, hedge funds lack the traditional core strengths of private equity, namely management experience and deep venture partner networks. Consequently, the two worlds are very complimentary and can leverage each other's skill set and structural advantages by blending the flexibility of a fairly rapid decision making process with the traditional core strengths of private equity. Unsurprisingly, we are seeing many private equity players setting up their own hedge funds, TPG-Axon being the most notable recent examples. And at the same time we are seeing more and more hedge fund managers, such as TCI, adopt a more private equity like approach to their strategies. There has also been a recent trend to use side pockets – a clever way to accommodate these illiquid and private equity investments within the hedge fund vehicle.

CW I think you'll see more private equity firms trying to get into the hedge fund business and more hedge funds delving into private equity, and the lines that separate the two will disappear over time. I don't believe that hedge funds will ever be as large as private equity in terms of buying companies and controlling them although I do think they'll be able to use their public market expertise to unlock value in private companies and then use the public markets to fundamentally hedge out risk.

Can you tell us about some recent deals and how you believe you're 'making a difference'?

CW We've been involved in some activism situations here in the US. There are three of real consequence since we've been active: the Highfields Capital bid for Circuit City which really got the ACG effort going, advising ValueAct Capital on its bid for Acxiom Corp and the successful proxy fight for Six Flags by Redzone LLC, which had a huge hedge fund component. On the financing side, we recently did a pre-IPO convertible financing for Vonage Holdings Corporation, a voice over internet protocol company. We created a highly structured equity linked security that hedge funds were very interested in. The transaction was a way for the company to raise quite a bit of money prior to going public. I think this is an area where we're going to be doing a lot more in the future.

SM In Europe, we recently closed on one transaction, Rutley European Property Ltd, which was a private placement of a Guernsey-based pan-European real estate fund. We are also in the market right now with a potential take-private of a public company that's in the entertainment business, as well as significant private capital placement for a European reinsurer. There are many discussions with both public and private corporate clients on the appetite for incremental, opportunistic capital which, in most cases, would not bring in control-seeking investors. These are all discreet discussions that are very well suited to the hedge funds. This is a very robust pipeline of potential transactions across all industry sectors.

What areas outside traditional public markets do you see hedge funds entering into?

RR Reinsurance is one. Katrina and Wilma wind storms in the US last year resulted in insured losses of US$60bn+, negatively impacting the balance sheets of reinsurers. As a result, rating agencies have increased capital requirements for property CAT writers – all driving a huge rise in rates. We have seen a number of dedicated vehicles being financed primarily by alternative capital providers. I think that trend is set to continue for at least another year. Real estate investment is likely to continue to grow, and then there are more obscure opportunities like film finance factoring and margin loans. Hedge funds will apply their expertise where there are good risk-adjusted returns to be generated.

SM I agree; I think the only sectors in which we don't expect to see the hedge funds becoming very active are the early stage businesses where the commercialization path is largely unproven – such as very young biotech or hi technology companies which are developing disruptive but unproven concepts. Those deals will likely remain an area that is more suited to straight venture capital for the foreseeable future. Overall, the landscape of emerging markets remains very attractive, as do the commodity-based businesses. The classic bricks and mortar infrastructure projects, project financing, all the areas that have been typical hunting grounds for commercial banks and traditional lenders or private equity players, are now being opened up to include hedge funds.

Craig Wadler
Head of Alternative Capital Group – Americas, Investment Bank

Craig Wadler joined UBS Investment Bank's Investment Banking Department in 2001 where he worked in the Consumer Products Group predominantly with retail companies. In 2005 he started the Alternative Capital Group in the Americas where his time is wholly focused on covering hedge fund clients. Recent transactions Craig has worked on include: raising US$250m in a pre-IPO convertible bond for Vonage Holdings Corporation, advising Redzone LLC on its proxy fight with Six Flags, advising ValueAct Capital on its bid for Acxiom Corporation, advising Highfields Capital on its potential acquisition of Circuit City and advising the Special Committee of Hollywood Entertainment on its sale to Movie Gallery. Prior to UBS Craig worked at Donaldson, Lufkin & Jenrette.

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How do you determine which hedge funds get access to which deals?

CW It's all about using our knowledge – knowledge of what the hedge funds can do, have done, what the decision making process involves and the likelihood of success. It is imperative for us to know what types of deals people like – size, industry, structure. And then it's a question of being able to get to the right person at those firms to get a decision made quickly such that our corporate coverage team has confidence in what we're advising them can be done. We want to interact with hedge funds that value what we are doing. And of course the flow of conversation and opportunity is a two-way street, so we're looking for people who see opportunities, introduce us to opportunities and who want to develop a relationship – it's not just about providing capital.

SM Clearly we can't service everyone, so we need to pick our spots and provide input to those managers that value our service. It tends to be clients who have the deepest and best relationships with the firm.

Craig, you are based in Los Angeles, Suzie and Richard you are both in London and you have a colleague, Peter Guenthardt, based in Hong Kong. Do you operate as a truly global team?

RR We're very focused on making what we do a global effort. We try to ensure that we don't become too regionally siloed. Of course, you have to have a certain regionalisation and that's why we've got an Asian presence, a European presence, and a US presence.

CW Clients can invest in any market whether they're in the US, Europe or Asia; we've got people on the ground in these regions so we can provide a service wherever they are and wherever they want to be – whatever is appropriate. Our goal has to be that no deals get done with the hedge fund investor base that from a banking origination standpoint we did not know about or think about. A lofty goal, for sure, but we know all the corporates, we know their financing needs and we know when it is appropriate to go to the hedge fund community to meet these needs.

SM What's important is making sure that we all stay in close contact, keep all channels open for information flow and coordination on accounts because the accounts don't necessarily break just by region. We are global in terms of our breadth of corporate and hedge fund coverage, our geographical reach, the product and of course our ability to reach across all of the different disciplines within the firm.

Suzie MacCagnan
Co-head Alternative Capital Group – Europe, Investment Bank

Suzie MacCagnan joined UBS Investment Bank's Investment Banking Department in 2000 through the acquisition of PaineWebber by UBS AG. While at PaineWebber, Suzie completed private equity assignments, public offerings and M&A assignments for a variety of Telecom and Technology clients. Suzie has worked on structuring and executing private placements for private and public companies in many industries including wire line, media and wireless, broadband, biotech, med-tech, healthcare services and financial institutions. Prior to PaineWebber, Suzie was with the Global Communications Group for Citicorp Securities dealing with structured financing for companies in the wireless and wire line industry sub-sectors for six years, and spent three years with TD Securities' Communications Group, focusing on media cable and broadcasting. Suzie holds an MBA from Fuqua Business School at Duke University and a BA from Amherst College.

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Richard Royden
Co-head Alternative Capital Group – Europe, Investment Bank

Richard Royden joined UBS in 2000 and ran the Equity Arbitrage Group (EAG) from 2000-2005. EAG services absolute return mandated investors in European event-driven situations such as M&A, spin-offs as well as softer event/catalyst/value situations such as stub, capital structure and holding company transactions. In addition to his EAG responsibilities, Richard has been involved with the general development of UBS's European equity hedge fund and prime brokerage franchise, and has responsibility for developing a number of structured transactions involving hedge funds and the Investment Bank's corporate customers. Prior to UBS Richard spent 10 years at HSBC Securities working in their OTC derivatives and structured products units in London and New York. Richard was educated at Stowe School and studied the CFIMP at London Business School.

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UBS Investment Banking Department – “trusted advisor”

Ken Moelis

Ian Gladman

What do hedge funds want from investment bankers? Ken Moelis, President of UBS Investment Bank, is dedicating a good deal of his time finding out – understanding their evolving needs, and sharing the knowledge that this segment is so keen to draw on. This relationship-based approach has much in common with the way in which the investment bank covers major corporates, dealing at CEO level, focusing on wide-ranging strategic issues in recognition of the increasing requirement from hedge funds for a ‘trusted advisor’, who can provide a holistic service. Moelis and Ian Gladman from the Financial Institutions Group that sits in the Investment Banking Department (IBD), talk about the different ways in which IBD is working with hedge funds, recent transactions, and how they envisage the future of what they would describe not as the ‘hedge fund industry’, but as the ‘alternative asset management universe’.

UBS Investment Banking Department

UBS's Investment Banking Department (IBD) has dedicated teams of investment bankers in Europe and the US focused on the asset management sector globally. In particular, UBS has focused on working with hedge funds and other alternative asset managers, providing services in three core areas: access to strategic assets for investment, access to distribution to gather assets to manage, and strategic advice on business development.

On a strategic advisory basis globally, UBS has been involved in a number of high-profile M&A transactions and has particular expertise in cross border transactions particularly in the specialist asset management sector, including the sale of Alcentra to Bank of New York, the sale of GAM to Julius Baer, acquisition of minority stake in FRM by Sumitomo and sale of Austin Capital to KeyCorp. In addition, UBS has acted in the acquisition of Baring Asset Management by MassMutual, the sale of Henderson's life services business and the sale of Threadneedle to American Express.

Globally, UBS has participated in all major capital markets activity in the sector. In Europe, UBS has acted as the lead manager for three of the largest IPOs for fund managers in recent years: Henderson Global Investors in 2003, New Star Asset Management in 2005 and Charlemagne Capital in 2006. In the US, UBS played an active role in the IPOs of Calamos and Cohen & Steers and the Secondary Equity Offering of Nuveen.

In debt, UBS lead-managed the first subordinated floating-rate note for Man Group, which was the first debt offering that qualified for regulatory capital issued by an alternative manager, requiring a substantial level of knowledge and experience in this market. It was also joint bookrunner for Nuveen's Senior Debt Offering and participated in BlackRock's Convertible Debt Offering in 2005.

UBS is corporate broker to New Star, AMVESCAP, Henderson and Charlemagne in Europe. In addition, UBS has undertaken a wide range of fund distribution mandates for clients such as AXA, JPMorgan Fleming, Jupiter, Fidelity, Thames River, Merrill Lynch and HSBC.

Corporate financiers and hedge fund managers – a burgeoning relationship

Asked about the reasons why there has been an increasing amount of investment banking activity in the hedge fund and funds of hedge funds industry and what is driving this trend, Gladman recalls that it was not so long ago that the focus of developed hedge funds was almost entirely on trading. This has changed. "Hedge fund managers are moving away from being day to day traders of stocks", he says. "The owners of these companies are managing their businesses for the long term – they need to think about how they are developing their business, what the strategy is and, at some point, they may want to think about how to achieve some liquidity for themselves or how to align their business with other businesses in order to accelerate their growth. At that point, they need advice and access to relationships. Which is why they talk to investment bankers like us."

Ken Moelis's experiences support this and underline the value of UBS's holistic approach. "We are meeting hedge fund leaders and getting to know them on the same basis as we know CEOs of companies. And we're offering them what we call a 'trusted advisor relationship' that gives them access to our best bankers for objective advice and idea flow. We want them to have faith in the relationship from the very top of the house that everything we are doing is in their best interest and that sort of trust takes time to develop."

This tangible investment of time is seen as an important commitment that IBD is prepared to make but which Moelis points out "will deliver more value to hedge funds than they will deliver to us over the next two to three years."

One fundamental factor that is leading hedge funds to seek involvement from investment bankers is the sheer scale of their wealth. "A number of hedge funds have now been established for a long time – 25% for more than seven years. They have built sizeable businesses. In Europe, there are now between US$325 billion of assets under management in hedge funds. There may be some pressure on margins in the future but, equally, there is probably a lot of growth to come. The value locked into these businesses is considerable – tens of billions of dollars. It is natural that the owners of some will want to achieve some liquidity as their business matures or want to explore strategic partnerships in order to expand their businesses," says Gladman.

Looking across the markets generally, he says "I believe we are at the crest of an initial public offering (IPO) wave; and at the crest of a mergers and acquisitions (M&A) wave. The fact that hedge funds have experienced tremendous growth and have highly dynamic entrepreneurs who want to develop their businesses, is simply adding to the increase in activity in M&A and IPOs. I expect it to continue. By floating, they are better able to use their shares as a currency to incentivise people, attract staff or acquire businesses to develop their strategy further. It is inevitable that the market capitalisation of the asset management sector will be significantly higher."

"We are at the crest of an IPO wave and the crest of an M&A wave …hedge funds are simply adding to the increase in this activity"

Timing – when is it right for hedge funds to consider M&A?

Faced with the implications of fast growth, a requirement for liquidity and the strategic necessity to develop their business, the method and the timing of such activity is critical to success. How do hedge funds – that in many cases comprise less than a handful of managers – negotiate the development and potential sale of their business in order to achieve their goals? And when is 'the right time'? "That", says Gladman, "is the sixty-four billion dollar question, and which makes the valuation multiples so variable between different transactions. Acquirers, by definition, want to buy a business, not an individual, so it partly depends on the individuals and their priorities. If hedge fund managers want to exit the business early to retire to the beach, it will be difficult to get that attractive multiple. M&A buyers are understandably reluctant to pay hundreds of millions of dollars for a company where effectively two people represent the whole business. It is very difficult to sell those kinds of businesses – the founders would have to be locked in for a long period of time with plans for a second generation. And if their business model is centred on a short term trading pattern, it is very difficult to replicate or institutionalise. The success that the Man Group, for example, has had over time is attributable to them having a replicable and scaleable business model that can expand its assets and still continue to deliver strong returns."

Liquidity – trade sale or IPO?

As hedge funds and fund of hedge funds mature, how do they achieve liquidity? Gladman outlines three principal options: a trade sale, a sale of a minority stake or an IPO. "The equity markets remain wary of pure single manager hedge funds because of their inherent volatility. They are looking more for a long term asset accumulation play, which could come from the alternative manager space, but from a broad range of products as opposed to a pure single strategy trading fund. We have not yet seen an IPO of a single manager hedge fund. In Europe to date, the purest alternative asset manager IPO that we have seen is that of RAB Capital, which manages a platform of single managers and a funds of hedge funds business. Other recent IPOs have come from asset managers whose primary focus is long-only money but who also run hedged assets – notably the recent IPOs of New Star in November 2005 or Charlemagne in April of 2006. To date, funds of hedge funds have tended towards the trade sale route because they are more institutional in their nature. They have been bought by institutional investors looking to expand into that space in order to offer their institutional clients access to the hedge fund universe through the fund of hedge funds concept."

Gladman makes clear that the decision to go the IPO or trade sale route is dependent on the managers' perception of growth prospects and, importantly, their personal goals – how long they want to be tied into the business and whether or not they want to be part of a listed company and subject to the scrutiny that comes with it. "A trade sale buyer will want to keep the key individuals locked in for as long as possible. Typically, we see periods of three to five years as being a requirement in a trade sale situation; with an IPO, it tends to be two to three years hence. If you build in place a succession plan, you are likely to be able to 'retire' more quickly through an IPO than you can on a trade sale. There is also a difference in terms of the valuation structure. For a trade sale, you will typically find the founding shareholders selling at least 50% and more likely 80-100% of their business, which means that they will have realised a significant portion of the value of their investments upfront. Importantly, the founders will often want to keep a stake, because they will be selling to a strategic partner who can benefit their business by giving them additional clients or distribution. Over time, the value of the stake the founders retain could be worth as much as the bigger percentage stake they have sold. They still have some significant upside in the business.

For an IPO, it is generally very unusual for the key shareholders and managers to sell more than 25% upfront. Subsequent sales will then be staggered. In the case of New Star, for example, sales by management are restricted on a sliding scale over a period of four years. In other situations, it has been three years. That is when they can sell; it is not necessarily when they will sell. For an IPO, your return as a founding shareholder is going to be more back ended. If you consider your business is at an early stage of a growth trajectory, you may consider it better for you to IPO the business in order to remove some value from the table upfront, but keep the bulk of your wealth there to be realised over time as the business grows in value. If you think you have travelled a long way, and may need a partner to reach the next level, you would be more likely to go down the trade sale route, realise the value of a substantial part of your business, and achieve some upside later with the help of your new partner."

So why did Alcentra opt for the trade sale route? The answer is for the best of positive reasons, says Gladman, "because Bank of New York made a highly attractive offer

> "We are getting to know hedge funds on the same basis as we know CEOs of companies… and we're offering them a 'trusted advisor relationship' that gives them access to our best bankers for objective advice and idea flow"

to the owners of the business and they felt that Bank of New York could give them access to distribution and institutional relationships that would significantly further develop their business. They realised a great multiple on sale, but have retained an interest in the equity which, over time, they hope will achieve a significant uplift in value."

As regards New Star and Charlemagne, New Star, explains Gladman, planned an IPO as a stepping stone in their development from the earliest point. They gave their managers shares in the company, rather than a yearly cash bonus, and considered it important to give managers liquidity, which an IPO made possible.

Charlemagne chose the IPO route primarily because they believed in the long-term growth prospects of the company and were at a relatively early stage in their development. "Although the business had existed for a number of years," explains Gladman, "it was still relatively small, at around US$5 billion of AUM. The founding shareholders believed that, while they had achieved a lot, they could easily achieve US$10 billion of AUM at some point in the future. They have retained a significant part of their shareholdings and plan to develop the business further, using the IPO as a way of locking in management, attracting further talent, allowing them to achieve their goals over time. And of course an IPO does not preclude a trade sale; you still keep all of your options open."

New Star's share price has increased from 225p at IPO to 437p, making it a star performer. "New Star's growth rate, in terms of net new money as a percentage of starting AUM, has been superb over the last few years and it shows every sign of maintaining that trajectory. For a company that is growing so fast organically, it deserves the premium rating that it currently has," says Gladman. Charlemagne came to market in April of this year and its debut was made more difficult by recent volatility in emerging markets. The price traded down initially but has now recovered to trade at a premium to IPO price. Gladman and the management of Charlemagne are confident regarding future profits, assets under management and the reduced reliance on performance fees.

Valuing alternative asset managers

On the subject of valuation and performance fees, Gladman explains that some interesting dynamics have occurred over the last two or three years. "The first is that valuations have risen. Generally, price to earnings (P/E) multiples are back up to the highest levels that we have seen. In some cases, they are on average higher than even the boom years in the late 1990s and early 2000s. Second, valuations in Europe have caught up with valuations in the US. Historically, there was a significant difference between the multiples in the universe of public traded companies in each market and that difference has narrowed. This does not apply to every manager in Europe but, generally speaking, the valuation gap has narrowed from a P/E difference of about five points to two. In some cases, the top rated European managers like New Star can trade in line with some of the better rated US companies. It is probably also true that there is more variation in Europe, because the range will stretch from the mid 20s to the low teens."

So how does the market value performance fees? Data for the market valuation of performance fees only exists in Europe, because there are no listed hedge funds in the US. Historically, the only data point has been Man Group, which has a significant element of performance fees. "Our view is that, where performance fees compromise less than around 10-20% of the business of a company, the market tends to overlook them and give a P/E based on the overall aggregate profits of the business. Examples of this would be Schroders, Henderson and New Star. They have performance fees, but the market does not value them separately; it only looks at a blended P/E. Where there is a significant performance fee element, for example, with Man and more recently, Charlemagne and RAB Capital, it will tend to disaggregate the performance fee profits and the management fee profits, and apply different multiples to each stream. Generally speaking, if you look at research reports from around the marketplace, you will see that most analysts apply a similar methodology, which traditionally was to apply approximately half the P/E, or twice the discount rate, if they were using a discounted cash flow (DCF) analysis to value performance fees, which are assumed to be more volatile. Interestingly, what we have seen is that the P/E multiples of traditional asset managers have expanded dramatically over the last year. When that relates to hedge fund managers, the valuation multiples applied to performance fees appear to have remained broadly as they were before, between four and six times earnings, whereas management fees multiples have now expanded to anywhere between 15 to 20 times in Europe. This amounts to an expansion of the discount that is applied to performance fees."

Of course one could argue that separating the management and performance fees revenue streams is artificial, says Gladman. "Performance fees are a necessary component of future management fees because if you do not have performance, you should not be paying a very high multiple of management fees, because those fees are not going to be growing very strongly."

That said, the market has also become more sophisticated in its approach to valuation of asset managers. "Historically, people would look at a fund manager and say it was worth 3% or 5% of assets under management, but the reality is that that is an inappropriate benchmark, because you could have a hedge fund that is generating 4-5% of fees annually on assets, which clearly is going to trade at more than 5% of assets under management. Equally, you could have an institutional life insurance contract that has only 10 basis points of revenue margin, and clearly that should not deserve to trade at 5% of assets under management."

"This shift", says Gladman, "is the consequence of a more sophisticated market. When the majority of asset managers were operating similar strategies it was fair to apply the same kind of multiples. Today, the variety of funds, funds of hedge funds, and styles of investment are such that investors are looking behind the AUM and focusing on revenue and profitability – i.e. cash flow – as the key determinant of value."

The future – from hedge fund manager to alternative asset gatherer

Talking about his outlook for the hedge fund industry as a whole, Gladman believes that growth will continue and points out that instead of 'the hedge fund industry' he sees the future in terms of alternative asset classes in a much broader sense. buy an independent or a well known, long-only manager from a bigger institution. Those are the kinds of institutions that I think we will begin to see in the next three to five years: something that has real scale in all three different areas. We are already seeing a good deal of convergence between hedge funds and private equity in their business activities."

Gladman believes that there will always be a place for a single strategy hedge fund, or a limited number of multiple strategy hedge funds, but that these types of businesses are more likely to remain private. Asset gatherers, who are thinking more strategically about how they want their business to develop, are more likely to seek the advice of investment bankers. "They are thinking about multiple businesses, their distribution strengths, their product range, and where alternative strategies sit within the broader panoply of asset gathering and asset accumulation.

> "We are investing time in developing these relationships, answering questions, providing information, getting to know these people better because we know we can deliver value over time. This is what investment banking is all about"

"When I think about hedge funds, I tend to think about single strategy-type funds, or multiple strategy funds, whereas the future lies in a company that will be an asset gatherer, using a number of alternative strategies, of which hedge fund-type strategies are just one. These companies will include private equity, property, commodities, and other 'alternatives'. I believe it is inevitable that at some point we will see one of the big private equity funds merged with one of the big hedge funds, using their firepower to

We are seeing a tremendous breaking down of the barriers between long-only managers, hedge fund managers, other types of alternative asset classes – fixed income, specialist fixed income, commodities, private equity, and so on. It is only a matter of time before 'mega-groups' will appear as specialists in all of those particular areas and these companies could have very significant funds under management. Such companies may well be too big to be bought. Clearly, if they want liquidity, they will have

"When asset managers were operating similar strategies you could apply the same kind of multiples. Today, investors are looking behind the AUM and focusing on revenue and profitability – i.e. cash – as the key determinant of value"

to come to the IPO market, because once you get above £1 billion of value for an alternative asset manager, it is very difficult to persuade a buyer that they are not paying £100 million per person. What the trade sales may do is help reshuffle some of the smaller assets by putting them together in bigger agglomerations. Equally, some people will pursue that strategy through the IPO market – listing as a smaller company and using their currency to merge or grow their business models over time. This is precisely where we can help."

Offering strategic advice

For fast-track firms that do not have a corporate development infrastructure in place, such strategic advancement is particularly challenging because it is outside their day-to-day activity. "We can provide advice to the CEOs of alternative managers as they consider their future strategy and, as and when they decide that they want to contemplate a corporate transaction or realise liquidity, on how best to navigate through this process to ensure that they meet their corporate and personal goals", says Gladman.

"We are looking at the bigger picture, investing in the relationship as a whole" says Moelis, "we're not just calling them with trading ideas, we're calling them in their capacity as owners of businesses, which for these senior managers is proving to be a refreshing change. And we're not asking 'do you want to sell or go public?' We're spending time with them, listening to them, providing information, access to relationships within the firm and saying 'what can we do for you?"

Access to knowledge, relationships, capital and liquidity is provided through the investment banking department (which has a dedicated global asset management practice) alongside colleagues in the Alternative Capital Group, across the Prime Services business and the wider network of the firm all of whom adhere to this core client-centric approach. "I've met with more than 40 hedge fund managers recently and they asked a lot of questions – on corporate trends, economics, sector-specific issues – we are investing time in developing these relationships, answering questions, providing information, getting to know these people better because we know we can deliver value over time. This is what investment banking is all about."

Ken Moelis
President, UBS Investment Bank
Ken Moelis joined UBS in 2001 as Head of Investment Banking for the Americas. He was appointed Joint Global Head of Investment Banking in 2004, and President of UBS Investment Bank in 2005. Prior to UBS Ken was with Drexel Burnham Lambert and then Donaldson Lufkin & Jenrette, where he became Head of Corporate Finance. He graduated from the University of Pennsylvania and gained an MBA at the Wharton Business School.

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Ian Gladman
Financial Institutions Group, Investment Bank
Ian Gladman joined UBS in 1995 to work in London IBD and moved in 1998 to Johannesburg to become Head of IBD South Africa, where he was involved in a number of major transactions, including the London listings of Anglo-American and Old Mutual and the hostile bid by Nedcor for Standard Bank. He returned to London in 2001, joining the Financial Institutions Group, and has been involved in a number of transactions for clients across the banking, life and non-life insurance sectors. Recent and current assignments include the demerger and listing of HHG and subsequent sale of its closed life book, the IPOs of Catlin, IG Group and Charlemagne Capital, the dual track sale/IPO processes for Saga and Alcentra, the sale of Abbey to SCH, the Hiscox Rights Issue and advising Standard Life on its demutualisation process. Prior to joining UBS Investment Bank, Ian worked at Goldman Sachs in the Investment Banking Division and J.P. Morgan in Debt Capital Markets. He graduated from Cambridge University with a degree in History.

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A&Q – a platform for single and funds of hedge funds managers

How do you build a hedge fund culture within a bank? How do you retain the talent that makes the difference? Very few firms have been able to build a platform as large and as successful as UBS's Alternative and Quantitative Investments (A&Q). Joseph Scoby, Head of the A&Q business credits much of this success to the entrepreneurial versatility inherent to UBS. Here he talks about the strategy behind UBS's single and multi-manager business and the opportunities ahead.

Joseph Scoby

Launched in 2000 with 90 employees and US$400m in client money, A&Q has grown substantially in the past five years though organic growth and internal restructuring to the current size of over US$44bn in AUM.

"We're in a unique position in that we operate as a boutique business within UBS. As a boutique, we had the necessary flexibility to build our business and at the same time benefited from having a world-class organization behind us. We have successfully promoted and rewarded entrepreneurialism while maintaining a very tight risk control and governance culture based on the original O'Connor standards," says Scoby. "Our management team is a group of entrepreneurial leaders who work closely together to establish direction, encourage collaboration and inspire our people. Our strategy is to recruit good people who can make money for clients and whose knowledge network makes everybody in our group a smarter investor – knowledge sharing is consistently incentivized."

Growth and convergence in the asset management industry

The asset management industry looks set to grow dynamically over the next five years, with an evolving universe of players and capabilities as evidenced by recent M&A activity. Scoby believes that this trend will continue as large firms fulfill their ambitious growth programs by buying, building or rounding out their alternative investment divisions. He also expects to see growing convergence between traditional and alternative providers including private equity and real estate. There is, he says, also a clear trend toward unbundling beta and alpha. It is all a matter of packaging. The questions that confront money managers are how best to build alpha and how best to package it. Asset managers will be focusing on this optimization over the next few years.

Asked about the greatest opportunities and challenges for the hedge fund industry and Scoby is clear about the industry 'coming of age'. He says, "The hedge fund industry is beginning to mature and become more 'institutionalized' but it is still a niche market in terms of size relative to traditional asset classes. If one believes in active management and in flexibility, one believes in hedge funds."

He also believes that the anticipated growth in interest from institutional investors will provide substantial opportunities for the hedge fund industry. Given the scale of some of these institutions, even a small allocation to the asset class as part of their overall asset allocation will have an enormous impact on the flows into this space. And he points out that with institutionalization will come increased demands in terms of regulation and reporting: "Various hedge fund strategies perform in different cycles of the market and profitable arbitrage situations ebb and flow, enhancing the importance of a broadly diversified portfolio. As investors continue to look for more risk, hedge funds and other alternative investments will continue to be a critical component of diversification."

So how well is A&Q positioned to take advantage of this evolution and these opportunities and confront the challenges? According to Scoby, very well indeed. By offering clients one of the widest product ranges and strongest global capacities in the alternative investment industry, A&Q can provide complete solutions to clients' alternative investment needs. The platform is strengthened by its ability to capture synergies available from operating both single and multi-manager teams. Additionally, A&Q

"If one believes in active management and in flexibility, one believes in hedge funds"

Alternative and Quantitative Investments (A&Q)

Alternative and Quantitative Investments, which sits within UBS Global Asset Management, is a globally integrated business created to provide alternative investment solutions. A&Q represents the hedge fund platform within UBS and also manages funds of hedge funds, funds of private equity funds and long only products. A&Q has more than 300 people, with offices around the world and comprises four alternative investment providers.

- **A&Q's US$12bn single manager platform has two well-known brands:**

  O'Connor, a global hedge fund specialist, led by Joseph Scoby in Chicago; the Equities group is led by George Locasto in Chicago and Currency & Rates run by Mike Dudley in London.

  DSI, a provider of enhanced equity indexed and quantitative equity hedge fund products, led by John Holmgren in Stamford

- **A&Q also operates two distinct multi-manager providers with US$32bn in Assets under Management:**

  Alternative Investment Solutions (AIS), a widely recognized global leader in institutional-based funds of hedge funds, headed by Bill Brown in Stamford.

  Alternative Funds Advisory (AFA), headed by Uli Niederer and based in Zurich, which provides clients with integrated alternative solutions including broad-based and sector specific funds of hedge funds and other alternative assets including private equity.

"In a rapidly growing and sometimes opaque market place, A&Q provides a strong culture of risk control and a high degree of transparency"

offers creative solutions for clients through its ability to tailor and structure products, leveraging the capabilities of other business groups within UBS.

Regulation and transparency

And in a rapidly growing and sometimes opaque market place, A&Q provides a strong culture of risk control and a high degree of transparency. Scoby says, "We actually welcome the recent moves to require registration of hedge funds with the SEC and similar initiatives across the globe. We have always been registered and have operated to the highest standards of our collection of regulators. In general, we like anything that levels the playing field and protects the retail investor. We are interested in the long term health of the business and these regulatory steps will help to achieve that."

Disintermediation of fund of hedge funds

Asked about the disintermediation of fund of hedge funds with institutions increasingly allocating to single managers and whether this is a concern for A&Q, he says "as the industry evolves, we anticipate client needs will span the full spectrum of alternative investments, ranging from less risky diversified fund of funds to more risky single manager strategies. As clients become more educated and experienced with hedge fund investments, they may begin to move along the spectrum, depending on their internal capabilities, risk appetite and investment objectives.

Scoby acknowledges that on entering the market, clients have traditionally utilized fund of funds to 'get their feet wet.' With substantial numbers of new investors predicted to enter the industry, he expects to see continued demand for fund of hedge funds believing that at the same time current clients may begin to allocate to single managers. He also points out that there is substantial differentiation among fund of fund providers, with some being able to offer a comprehensive control infrastructure, a thorough investment process with a global presence, and superior client service with others offering closer to an index type product with inferior client service. "Given the breadth and depth of our platform, A&Q is well positioned to handle all of these needs across the full spectrum of single manager and multi-manager products," he says.

Clients, innovation, talent

Scoby's plans for the next three years remain focused on clients. "Client needs drive our business so our objectives are focused on: consistently providing them with exceptional returns through reduced exposure to moves in the broad market – profiting from market inefficiencies, providing the highest level of client service, and strategically and innovatively reacting to the evolution of the market and client needs with new products and capabilities", he says.

He goes on to describe anticipated growth in both the institutional and retail client segments with expectations for significant demand coming from Asia Pacific, adding the importance of innovation and talent. He says, "innovation is inherent to our business; it is an essential part of our drive and commitment to meet our clients' needs. We have recruited new talent and added new capabilities on the platform including five new funds launched so far in 2006. Our plans focus on continuing to attract new teams and launch new products that will meet client demand and capitalize on identified opportunities in the market."

"Innovation is inherent to our business; it is an essential part of our drive and commitment to meet our clients' needs"

Joseph Scoby
Head of Alternative and Quantitative Investments,
Global Asset Management

Joseph Scoby began his career with O'Connor & Associates in 1987 and joined UBS in 1991 when O'Connor became part of the former Swiss Bank Corporation. From 1995–1999 he was Head of US Equity Risk Management and Joint Head of US Equities at UBS Investment Bank. As Head of Alternative and Quantitative Investments he has overall responsibility for managing the business and also oversees the quantitative trading effort for O'Connor Equities, a specialist hedge fund provider within Alternative and Quantitative Investments. Joseph is a Member of the UBS Group Managing Board.

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A winning culture... the key to a successful single manager platform

George Locasto, Head of Equities at O'Connor, which sits within Alternative and Quantitative Investments (A&Q), oversees the global investment team of more than 80 professionals in Chicago, New York, London and Hong Kong. The team runs strategies across a broad investment spectrum including multi-strategy, convertible arbitrage, long convertibles, credit arbitrage, fundamental market neutral, directional long/short, various quantitative strategies, and private investments in public equities. Based in Chicago, Locasto is also the portfolio manager for the UBS Global Equity Arbitrage Fund. He talks about the opportunities in 2006 and explains some of the background to the platform, which has now been in place for five years.


George Locasto

"There are now 11 funds across a variety of strategies, so the platform has certainly evolved", he says. "It was originally predicated upon capitalizing on our 25+ year track record in equities, bonds and derivatives trading, research and risk management. What's interesting is how we plan to improve upon and add to this platform."

Locasto explains that this is twofold: building on the operational strength of the platform and the incremental addition of new investment strategies. With respect to the first part – operationally the back office systems are extremely robust and while Locasto and his team are constantly striving to improve them, in many ways, he says, this is an exercise in fine-tuning. In fact, once they have identified a new investment strategy, it's a relatively simple exercise for them to bolt it into place operationally.

Fund Name	Strategy	Assets Under Management**
UBS Global Equity Arbitrage *	Global Equity Arbitrage is a multi-strategy fund that seeks to realise consistently high risk-adjusted returns by dynamically allocating to a combination of the following strategies: Fundamental Long/Short Equities (market neutral and market directional); Convertible Arbitrage ; Merger and Acquisition Trading (primarily merger arbitrage); Multi-Discipline Strategies; Credit Arbitrage; and Currencies and Rates.	US$915.6 million
O'Connor Global Fundamental Long/Short	Fundamentally based long/short portfolio focusing on six mature global sectors (with multiple sub-sectors): Consumer, Durables, Energy, Financials, Healthcare and TMT (Telecom, Media, Technology). The approach is reasonably short term in nature with higher turnover focused on trading around catalysts and specific corporate events.	US$2,289.2 million
O'Connor Long/Short Equity Opportunities	Long/Short Equity Opportunities invests predominately in US equities, but may invest in other G10 countries in specific industries when opportunities arise. The fund is discretionary and takes advantage of opportunities across multiple sectors, capitalisations, and growth / value categories and attempts to profit from both alpha and beta.	US$163.1 million
O'Connor US Equity Long/Short Investing	US Equity Long/Short Investing is a fundamentally driven long/short equity portfolio that utilises a proprietary research process. The portfolio is adaptable to changing market conditions and has a geographical focus on the US equities market, with the ability to invest up to 20% in non-US markets.	US$41.5 million
O'Connor Global Convertible Arbitrage	Global Convertible Aribitrage is a market neutral portfolio with an equity and credit selection criteria focuses on identifying attractively structured convertibles priced at or below perceivd fair value. The strategy considers all securities in the capital structure when hedging, as well as asset swaps and credit default protection.	US$714.1 million
O'Connor Credit Arbitrage	Credit Arbitrage is predominantly market neutral with a focus on capital preservation and exploiting apparent mis-pricings of securities across the capital structure. The fund identifies value through the following four strategies: relative value arbitrage (50-75%), event driven arbitrage, capital structure arbitrage and structured product arbitrage.	US$203.4 million
O'Connor Global Convertible Bond	Global Convertible Bond focuses on large capitialisation companies and predominantly seeks to profit from long positions with selective shorting to hedge (using common stock, options or other securities). Swap trading is employed to optimise exit and entry point in convertible positions.	US$137.1 million
O'Connor Global Quantitative Equity	Global Quantitative Equity invests in equities of developed market countries comprising the MSCI ACWI index (Asia, North America, and Europe) and aims to capture security mispricings across these countries and also across industries resulting from institutional rigidities and behavioural biases with a disciplined, model driven and risk controlled investment process.	US$968.3 million
O'Connor Multi-Discipline Strategies	O'Connor Multi-Discipline Strategies is a basket of distinct historically low correlated low alpha sources, which provides diversifed exposure to long/short equity, quantitative equity and fixed income strategies. The fund attempts to achieve risk-adjusted returns by dynamically allocating capital across the following strategies: Global Quantitative Equity (GQS I & II); O'Connor US Long/Short Quantitative Strategies, US Equity Long/Short Investing; European Statistical Long/Short; Long/Short Equity Trading Opportunities; DSI Long/Short; Tactical Trading Strategy; and Quantitative Bond Strategy.	US$330.7 million
O'Connor PIPES Corporate Strategies	O'Connor PIPES Corporate Strategies will primarily invest in public and private companies through privately negotiated transactions. The strategy seeks to realise attractive risk-adjusted returns in any type of equity market environment. The portfolio will be run with a long bias and a majority of the transactions will be in equity or equity-linked securities.	US$24.2 million
UBS A&Q Asia Property Cycle	UBS A&Q Asia Property Cycle aims to achieve high absolute returns by allocating capital dynamically among stocks that are believed to be prime drivers in different phases of a property market cycle i.e. rotating from early movers (typically property) to late movers (typically banks, consumers) by exploiting market trends and apparent mis-pricings.	US$98.9 million

** to be renamed in June UBS Multi-Strategy Alpha*

*** all assets under management are in US$ as at 1 April 2006*

“Our goal is to make further additions to the platform with complementary strategies that can simultaneously offer a further source of alpha to our clients and serve to broaden and deepen the information flow across our entire global investment team”

In terms of identifying new strategies, this, he says, is a matter of searching for the talent that fits the A&Q culture and alpha that is not too far astray from core strengths. “Our goal is to add talent that will make our existing alpha producers smarter and leverage our ideas. This is why we have recently been adding long/short equities and directional equities because fundamental analysis is a core strength and has been a key contributor over the past few years. The build out of the quantitative portion of our platform has also been fertile ground as we add uncorrelated strategies to complete the puzzle,” he says. Locasto is keen to point out that A&Q's unique structure at UBS enables him and his team to access and draw from an enormous pool of global talent. He believes that the UBS brand allows wider access to information flows which delivers a significant advantage over competitors.

UBS Global Equity Arbitrage Fund

In addition to his role as Head of Equities at O'Connor, Locasto is manager of the Global Equity Arbitrage (GLEA) fund. With US$900 million+ in assets, this actively allocates across a combination of the following in-house strategies: Fundamental Market Neutral Long/Short, Merger & Acquisition Trading (primarily classic merger arbitrage), Convertible Arbitrage, Multi-Discipline Strategies, Credit Arbitrage, Currency and Rates, Long/Short Equity Opportunities and US Equity Long/Short Investing. “We focus on these strategies because of our experience in these areas and the synergies created by combining them in the multi-strategy fund” he says.

“...the UBS brand allows wider access to information flows which delivers a significant advantage over many of our competitors”

Locasto explains, “a correlation matrix highlights the attractiveness of combining these strategies into a single fund. While the core leadership of this fund remains one of the most stable in the industry, GLEA has evolved and adapted over time, evidenced by the increase in the breadth and depth of the platform. Additionally, our allocation and opportunistic use of leverage has become far more dynamic as our qualitative assessment and quantitative data mining have become increasingly powerful tools. Our returns have increased materially with only a marginal up tick in the fund's volatility. All of GLEA's strategies are focused on liquid securities, and the resultant risk and return profile compares very favourably to those of our peers.”

Future opportunities

Asked about the most exciting future opportunities, these, says Locasto, are to be found in the APAC region. He believes that GDP growth there should continue at a pace that eclipses the rest of the world, and that trading margins are still potentially wider with markets continuing to develop at a rapid pace. The recent proliferation of hedge funds in this region should also continue, which will further stimulate trading activity.

He anticipates an increase in volatility and liquidity which should broaden the opportunity set for hedge funds across asset classes and believes that takeover activity should remain vigorous as companies strategically deploy their cash and reposition themselves globally. “We will capitalize by constantly adapting and redirecting our resources efficiently across our existing suite of products.

With the proliferation of hedge funds, return distributions have become distorted for an increasing number of 'crowded' trades. The distortion creates great opportunity to extract outsized risk adjusted returns by properly employing game theory, unique information flow, and most importantly independent thinking,” he says.

New funds

As for new funds, Locasto has already launched one new fund on the equities platform this year – the UBS A&Q Asian Property Cycle Fund, which is managed from UBS's Hong Kong office by Franklin Lam who recently joined A&Q from the Investment Bank. 2005 saw the launch of the O'Connor Equity Opportunities Fund, which is managed from the New York office by Christine Hahn and the US Equity Long/Short Investing Fund, which is managed by Rob Piton in Chicago. These funds, he explains, all share a common general theme – to offer more positively skewed volatility and beta to the market. “While we are still building our market neutral efforts this recent suite of products diversifies our menu,” says Locasto, “our goal is to make further additions to the platform with complementary strategies that can simultaneously offer a further source of alpha to our clients and serve to broaden and deepen the information flow across our entire global investment team.”

A maturing industry with a growing need for talent

As the industry matures, Locasto is keenly aware that the requirement for talent remains "of vital importance". "Over the years", he says "we have approached this from a number of different directions – developing talent from within, recruiting from outside the organization and nurturing talent straight from universities." Many of his managers started at O'Connor as analysts or traders. As they have developed and excelled in their roles, they have gained increasing levels of responsibility. "It's a natural evolutionary process", he says. "Identifying promising university students and offering them attractive internship programs is a very successful tool for building and training the teams of the future. Education, curiosity, creativity, and teamwork have always been and remain integral components of O'Connor's strong and collegial culture."

The right prospects

Locasto is modest about his winning approach and pays credits to his diligent team and the information flow so vital to its success: "We aim to continue to identify attractive investment opportunities across our trading strategies and to capitalize on high Sharpe ratio trades within the individual strategies. While doing so we minimize directional systematic risk and invest with a defined profit target and loss limit," he says. New managers will support this process, some of whose interest in A&Q has come as something of a "welcome phenomenon" to Locasto. He says, "we are receiving reverse inquiries from experienced non-A&Q managers who have been unable, for whatever reason, to reach critical mass in their own company's asset base. In a nutshell, they are very attracted to our information flow and substantial operational infrastructure." And no doubt, those who lead the way.

"…an increase in volatility and liquidity which should broaden the opportunity set for hedge funds across asset classes and takeover activity should remain vigorous"

"…return distributions have become distorted for an increasing number of 'crowded' trades. The distortion creates great opportunity to extract outsized risk adjusted returns by properly employing game theory, unique information flow, and most importantly independent thinking"

George Locasto
Head of Equities, O'Connor, Alternative and Quantitative Investments, Global Asset Management

George Locasto is the Head of Equities at O'Connor, a key hedge fund operator within Alternative and Quantitative Investments (A&Q). George is responsible for all aspects of the equities trading program for O'Connor. In addition to managing investments, George works closely with other members of the A&Q management team to ensure investment and logistics priorities are met and in building business plans for the O'Connor trading platform overall.

Prior to assuming his current role, George was Head of Convertible Arbitrage Trading at O'Connor. Previously, he was Head of US Proprietary Convertible Trading at UBS Investment Bank. George joined O'Connor & Associates in 1986, which became part of the then Swiss Bank Corporation in 1991. George has traded financial instruments since 1986 with experience in equity market neutral strategies, complex derivatives trading techniques and associated risk management. Before starting his career as a trader, George worked for Arthur Andersen & Co. as a tax manager. He has a BS and JD from Indiana University, US.

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"...more opportunity than challenge"

William Brown

William Brown, Chief Investment Officer of the Alternative Investment Solutions (AIS) team, a key multi-manager provider within Alternative and Quantitative Investments, talks about the opportunities and challenges of investing in hedge funds.

The AUM of AIS has grown significantly from US$18.9 billion at the beginning of 2005 to US$24.9bn at the beginning of 2006. From which types of clients have you seen the strongest growth and from which regions?
A modest part of our growth came from positive performance in 2005.

"We believe the benefits of our size definitely outweigh the limitations, but the benefits of size go hand-in-hand with the strength of the UBS reputation and brand name"

However, we had new investment inflows across the entire spectrum of client segments from high net worth clients of UBS Global Wealth Management & Business Banking to large pension funds globally. Fund of funds tend to be the first step and optimal structure for both private clients and institutions given the diversification benefits they provide, plus the access to a global research platform that a group like AIS at UBS can provide.

In particular, two factors have contributed to the growth of pension assets. First is the growing recognition by consultants and pension investment committees of the role that alternatives play within a portfolio. Second is the fact that pensions previously had very little, if any, allocation to alternative

"The overall level of capacity increased recently, particularly with previously closed managers, as some fund of funds experienced year-end redemptions. We were able to take advantage of much of this capacity as we continue to have net inflows into our products"

investments. Growth has been the strongest in the US and Canada followed by Asia (Japan, Korea, Australia) then Europe. Within Europe, the UK pension market has been the quickest to increase its allocation to alternatives.

What expectations do you have for net inflows in 2006? Are you focusing your marketing efforts on particular client segments or regions?

Lately, we have been seeing smaller institutions, particularly in Europe, showing interest in our products. Certain firms have realized that they do not have the internal infrastructure to invest directly in single hedge funds, and so take comfort in allocating with a firm like UBS to perform the due diligence, monitoring and portfolio construction.

For 2006, we would like to grow by at least 20% including organic growth, with new capital split relatively evenly between institutional and high net worth clients. We believe this growth rate is attainable. Over the past three years, we have enhanced our global research platform and client service capabilities, making them deeper, more scalable, and more efficient from both a headcount and technology perspective. This is further augmented by the managerial and financial support of UBS AG. We are currently working on several new products, including a broad-based globally diversified fund of funds for ERISA investors, a similarly focused product for investors in domestic European markets, plus an Asian-themed fund of hedge funds portfolio that is likely to have a broad appeal among clients given recent sustained interest in the region.

Your size must create certain advantages. What edge do these advantages give you? Or is size the enemy of performance?

We believe the benefits of our size definitely outweigh the limitations, but the benefits of size go hand-in-hand with the strength of the UBS reputation and brand name. For example, when it comes to sourcing new managers, high-profile fund launches frequently choose to contact a shortlist of potential investors and subsequently close quickly, so our size and reputation typically mean that we make that shortlist. Another advantage of our size and scope of products is our ability to transfer hedge funds across products to the benefit of our clients as their portfolio needs change. This is pure added value from a liquidity standpoint. Being part of UBS also allows us to use the firm's balance sheet for capacity reasons in order to take advantage of short-lived opportunities.

Size is not an obvious enemy of performance, as we have outperformed many smaller firms on an absolute and risk-adjusted basis. We have been able to continuously identify and secure top-quality hedge fund capacity throughout our history, thanks to our group's reputation and robust research process, and thanks in part to the dynamic nature of the hedge fund industry itself. New investment opportunities are continuously created, even as older opportunities are competed away. With respect to these dynamics, we believe it is critical to develop and maintain independent forward-looking research. We have expanded our research capabilities on a global basis to evaluate and take advantage of every new hedge fund opportunity, both for performance reasons and to support growth.

What limitations does your increasing size place on you? How has your size affected your investment strategy and process?

The primary limitation to growth of assets means that at times, we may be a larger percentage of an underlying fund's assets, but owing to banking regulations, we must remain below 25% in certain of our products. Certainly, the amount of assets we have invested necessitates a disciplined and efficient investment process with top-notch systems to facilitate that process. Having significant assets and being a part of UBS are huge advantages in supporting a deep infrastructure and global team, enabling ongoing innovative enhancements to the process. Importantly, our size allows us to remain at the forefront of operational due diligence, being one of the first groups to maintain an internal operational due diligence research team that is also part of the investment team. We believe this integration allows for better communication, more rigorous analysis and, overall, a more efficient process. For example, this synergistic combination allows the operational due diligence team to maintain a deeper understanding of the strategies, while helping the investment team to better understand issues such as the valuation of complex securities.

Where do you see further capacity coming from – existing investments, fresh hedge fund talent, new strategies and developing regions…?

Capacity, which we constantly evaluate, is dynamic and is a function of both the underlying fund managers and the market opportunities within the strategies themselves. Currently, we are seeing more than adequate availability with top-level hedge fund managers, in both established and new funds, in every region and strategy. Interestingly, the overall level of capacity increased recently, particularly with previously closed managers, as some fund of funds experienced year-end redemptions. We were able to take advantage of much of this capacity as we continue to have net inflows into our products. AIS also has the ability to use the UBS balance sheet for our clients to hold capacity in high quality managers.

How do you see the evolution of the fund of hedge funds industry over the next five years?

I believe that it will continue to grow as will the hedge fund industry per se, but with increasing bifurcation between the larger and smaller firms in terms of capabilities and client segmentation. Over the past few years, the fund of hedge funds industry has grown at a much faster rate than in prior years, increasing its market share of the hedge fund industry overall. Differing estimates claim funds of hedge funds manage somewhere between 30 and 60 percent of the US$1.5 trillion in hedge funds.

Both hedge funds and funds of hedge funds look and behave very differently than they did in their boutique days of ten to fifteen years ago. Over the next five years, I expect the fund of hedge fund industry to become more oligopolistic. The consolidation that we have observed in the recent past will continue. The reason for this is the institutionalization of the whole hedge fund industry. Most institutional investors prefer a certain critical size and ever more robust due diligence standards in terms of a fund of hedge fund provider. It raises their comfort level. This fact has caused the barriers to entry of the institutional arena to increase. I believe this will continue to accelerate over the next five years, with the gap between institutional quality providers and boutiques widening further.

Institutional investors will demand more hedge fund capacity to help manage asset/liability problems, and will drive greater sophistication in global alpha sourcing capabilities, operational due diligence, portfolio construction and risk management, product engineering and liquidity provision. Smaller firms will not be able to efficiently meet the sophistication level required on all these fronts.

What are the greatest opportunities and challenges facing the fund of hedge funds industry? How are you positioning yourself to take advantage of these opportunities and how are you confronting the challenges?

The institutionalization of the hedge fund industry is both an opportunity and a challenge – we believe it to be more of an opportunity than a challenge. Our main focus at AIS remains the institutional investors, who have become ever more sophisticated with respect to hedge funds over the past several years, and help drive us to make our research and portfolio management processes ever more robust. Many of these investors have gained comfort through experience with pilot programs and knowledge sharing and are now ready to increase their allocations to absolute return strategies. Some have built in-house sourcing capabilities, yet they acknowledge the challenges of maintaining global scope and scale. Clearly, the number one challenge for funds of hedge funds will be to secure top quality hedge fund capacity for the enormous institutional demand in the pipeline. Our size and reputation helps us here.

One major opportunity for funds of hedge funds is the globalization of the hedge fund industry. For most of its 57-year history, the hedge fund industry has been primarily a US affair in terms of manager location. However, this has changed. Europe started to emerge around 2000 and Asia around 2004. We feel well positioned as we have investment staff in five financial centers in the three main geographical areas.

Certainly, hiring and keeping talented investment professionals is always a challenge. We've established a deep global research platform of 26 investment professionals with offices in London, Zurich, Hong Kong, Tokyo and Stamford, CT (with a base camp in nearby New York City) and have plans to hire six to eight new investment professionals this year. The team includes professionals with extensive capital markets backgrounds, which we believe is key in evaluating hedge fund strategies, risks and managers. We look at research with a focus on the dynamic

“Institutional investors will demand more hedge fund capacity to help manage asset/liability problems, and will drive greater sophistication in global alpha sourcing capabilities, operational due diligence, portfolio construction and risk management, product engineering and liquidity provision. Smaller firms will not be able to efficiently meet the sophistication level required on all these fronts”

"The global economic and market environment is continuing to shift away from one that's low risk premium and creditor-friendly to one that's riskier, and shareholder-friendly…which will benefit many hedge fund strategies"

drivers of risk and return, continuously adhering to our independent, forward-looking investment philosophy. Overall, we have tried to instil within the group a team approach, and a culture of money management. This environment and culture is attractive for employee retention as well. Also, steps are taken through deferred compensation and other monetary and non-monetary forms to mitigate personnel departures, and the UBS brand is extremely attractive.

Other challenges include ongoing changes in the hedge fund regulatory environment, such as Basel II and specific country regulations. On the regulatory front, we have attempted to turn these challenges into opportunities by launching products that have been approved by regulators in specific 'regulatory intensive' countries. Last year, we launched broad-based, diversified fund of funds for Switzerland and Italy. In 2006, we are seeking approval for a product in Spain as well as a broad-based, diversified product for ERISA investors.

Which strategies and regions do you think will perform the best and where do you see the most interesting opportunities in 2006?

This year, the opportunity set for hedge funds looks quite different to us than over the past two years. We believe the global economic and market environment is continuing to shift away from one that's low risk premium and creditor-friendly to one that's riskier and shareholder-friendly, as once steep interest rate curves flatten and companies continue to spend down the massive cash balances they had previously accumulated. The new Fed Chairman, new unpredictability in monetary policy, new increases in sovereign and corporate issuance, new surges in shareholder activism and merger activity, and new elections in an increasingly bifurcated world of surplus and deficit nations are all drivers of increasing uncertainty. We believe this uncertainty will eventually result in a measurable increase in volatility and risk premium, which will benefit many hedge fund strategies.

Our outlook for equity hedged strategies remains positive across geography, time frames, and sectors. Underpinning this positive outlook includes a widening opportunity set illustrated by acceptable levels of individual stock dispersion, increasing shareholder activism, particularly in Europe, M&A activity and increased willingness by US corporations to utilize cash hordes to enhance shareholder value. Recently, we upgraded our outlook for trading strategies, both discretionary and systematic. We believe the current environment provides more opportunities based on fundamentals and increased selected product volatility, yielding greater tactical trading opportunities. Strong opportunities within specific products, such as commodities, are providing specialized traders with significant opportunities for trading and profit. The opportunity set for hedged trading in emerging markets is improving and also supports our upgrade in the trading strategies.

The search for alpha is driving hedge fund managers into more illiquid and esoteric strategies. What is the next frontier in the search for alpha?

One of the constants in the quest for alpha is change. The harvesting of specific bits of alpha depletes that part of the total alpha set, until new market forces create more supply. Some strategies regularly cycle through feast or famine due to their non-constant alpha supply, particularly issuance-driven and volatility-driven strategies. Some strategies see their alpha become permanently competed away, particularly so for less innovative approaches. New strategies emerge as regulatory environments change. New opportunities appear suddenly as economic forces clash with non-economic constraints to spur even large market participants to ignore relative or even absolute value.

The search for alpha is truly dynamic. It increases the efficiency and liquidity of financial markets, which is what drives some hedge fund managers into illiquid and esoteric strategies. Once a strategy is no longer illiquid and esoteric, the alpha has probably gone. For example, plain-vanilla convertible arbitrage a few years ago was illiquid and esoteric for most of the investment management community. This has changed. The alpha is smaller since issuance and volatility is compressed, but also because many shops know how to do it these days. The case is similar for plain-vanilla merger arbitrage. So, illiquidity and esoteric strategies are part of the equation. However, many hedge funds have evolved into more sophisticated shops even within convertible arbitrage and event-driven trading, for example, adding fundamental credit capabilities and shareholder activism to their arsenal.

I should also mention that alpha can be very manager-specific. So there are managers who consistently generate alpha even in a fairly efficient market such as the US stock market. At AIS, we believe that a larger part of alpha

> "We strongly believe that our clients should be compensated by higher expected returns for taking higher liquidity risk"

is attributed to the manager, and to a lesser extent to the strategy.

Certain opportunities in Europe and Asia are more esoteric and illiquid than in the US, providing a new frontier for hedge funds. Local market home turf advantages exist for key players. Shareholder activism globally is on the rise, and hedge funds managers have been pushing company management to unlock value for shareholders with greater success than ever before, teaming up with other hedge funds to advocate changes to a degree that mutual funds never have.

Another frontier that some managers have pushed is the boundary between hedge funds and insurance/reinsurance companies, real estate investment companies and private equity companies. In each of these cases, underwriting the underlying assets/risks is less transparent than in more liquid markets, and the hedge funds can bring to bear sophisticated hedging techniques and product engineering capabilities that traditional firms might lack, not to mention enormous pools of capital. Liquidity provision has been a key component in many hedge fund strategies for years – the challenge for them now is to match the worse liquidity and structural complexity of these frontier strategies to their investors' liquidity.

Many funds and recent launches are imposing worsening liquidity terms (lock-ups, redemption frequency, notice periods, gates…). Is liquidity of your underlying funds worsening – or will you simply not invest in funds with certain terms? Given this worsening liquidity environment, how does this impact your risk management?

Liquidity management is of paramount importance to our business. Indeed, we have seen a tightening of terms among funds in recent months, particularly US entities, surrounding the avoidance of SEC registration and other business-related reasons, although in our manager selection process we encounter quality prospects that run the gamut of lockups, redemption frequency, and other terms. However, because of the breadth of our coverage of funds and the speed at which we are able to deploy capital, we are not forced to sacrifice performance for liquidity concerns.

If a desirable manager moves to a longer lock-up period, we first question whether these terms are appropriate given the nature of the strategy. For some strategies, a longer redemption term may actually be a positive from a risk perspective, since the manager will not be forced to redeem shares to 'hot money' investors at inconvenient times. On the other hand, funds that demand extreme lock-ups that aren't commensurate with the nature of their businesses may not be desirable investments. We tend to avoid the recent trend of three year-plus lockups unless the manager offers a significant amount of excess alpha. In general, we prefer a manager to maintain liquidity that is in line with the underlying securities in the portfolio. We strongly believe that our clients should be compensated by higher expected returns for taking higher liquidity risk.

These days, skill in fund of hedge fund portfolio construction definitely includes constraining for liquidity risk. We are constantly assessing not only our underlying managers' ability to unwind positions and their weighted average cash flow terms, but also our own investors' redemption schedule, likelihood of redemption, and possible duration mismatching. The current liquidity environment has caused us to become even more critical risk managers of our portfolios.

William Brown
Chief Investment Officer, AIS, Alternative and Quantitative Investments, Global Asset Management

William Brown joined UBS in 2003 as a Senior Investment Officer of the O'Connor Multi-Manager investment team, which became AIS in March 2004. In 2005, he was appointed Chief Investment Officer and is Chairman of the AIS Investment Committee with responsibility for all aspects of AIS. Prior to joining UBS, Bill held a number of senior roles within the alternative investment industry including: Managing Member of Eudaimonia LLC, a private investment advisory firm, Chief Investment Strategist, Director of Investment Strategies and Senior Research Analyst at Tremont Advisors where he was the principal architect of Tremont's top-down strategic investment process. Previously, he spent ten years at IFC in Stamford, CT, where he was a partner and trader for the group's Global Macro hedge fund. Bill has over 18 years of investment industry experience and holds a BA from the University of Rochester.

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Investing in hedge funds for private clients

Hansjoerg Borutta

Tim Bell

UBS Global Wealth Management & Business Banking has seen phenomenal asset growth over the last few years – with a significant portion of investments channelled into hedge funds and funds of hedge funds on behalf of its private clients. Hansjoerg Borutta and Tim Bell talk here about the firm's approach to investing in hedge funds. Based in Zurich, Borutta heads the team responsible for the approval, structuring and distribution of hedge funds globally (ex-US domestic) to their clients. Bell is part of Borutta's team and runs the UK Alternative Advisory business in London.

UBS Global Wealth Management & Business Banking

UBS Global Wealth Management & Business Banking (Global WMBB) is one of the world's largest wealth managers with more than 140 years of experience and some US$1.5 trillion* under management. Global WMBB is committed to meeting its clients' needs through its client oriented advisory approach, creating long-term personal relationships and providing a comprehensive range of products and services individually tailored for wealthy clients around the world.

*Source: UBS AG 31/12/2005

Growth and collaboration with UBS Global Asset Management and the Investment Bank

Given the scale of UBS, it is no surprise that UBS Global Wealth Management & Business Banking (Global WMBB) is one of the largest investors in hedge funds in the world. In order to achieve the scale required and often for regulatory reasons, the majority of these investments are held through either fund of hedge funds or structured products. Borutta and his team in Zurich are responsible for approving the respective funds and for managing the product platform. Direct investment into single manager hedge funds is currently more common in London under Bell's direction for larger hedge fund investors. "Hedge funds are, for our UK clients, one of seven asset groupings – cash, equities, bonds, private equity, commodities, real estate and hedge funds," says Bell. "We advise our clients on the appropriate allocation to hedge funds within an overall portfolio strategic asset allocation, dependent upon their needs and what is suitable for them. Every country is different, but in the UK our clients have certainly bought into the principle of broad diversification in alternative assets. The typical starting point now for many clients is around 45% in alternatives – made up of 15-17% in hedge funds, 13% in real estate, 10% in private equity and 5% in commodities."

> "It has made absolute sense to add hedge funds into the portfolios of our clients …they give our clients access to alpha and are a good source of portfolio diversification"

The strong growth in assets of Global WMBB coupled with the important weighting into hedge funds in UBS's strategic asset allocation, has resulted in a significant shift into hedge funds on behalf of the firm's clients over the last four years. "It has made absolute sense," says Borutta, "to add hedge funds into the portfolios of our clients for two important and obvious reasons: first, hedge funds give our clients access to alpha and second, they are a good source of portfolio diversification."

Bell believes that being part of the UBS group has been a major advantage for Global WMBB. "We could not have deployed the volume of capital that we have over the last four years without the close collaboration of other parts of UBS – most notably, the Alternative and Quantitative Investment team within UBS Global Asset Management, and the Risk Management Products Structuring team within the Investment Bank."

Once the decision was made to increase significantly the percentage of clients' portfolios into hedge funds, the collaboration with Alternative and Quantitative Investments allowed Global WMBB to deploy the necessary capital rapidly. "We believe we stole a march on the competition" says Borutta. "There is only so much talent available and the sums we needed to deploy were substantial; we already had the expertise to identify the talent within the firm and it was simply a question of putting the right linkages in place throughout the UBS group to secure that talent for our private investors. Hence, single manager due diligence was outsourced to that team to develop proprietary fund of hedge funds. It clearly made sense from a group perspective not to duplicate this effort. The whole operation was done with great stealth." Of course, Global WMBB is not limited to internal fund of hedge funds products. Based on a rigorous due diligence process (that applies to in-house funds as well) Borutta's team approves and invests in external fund of hedge funds – wherever the opportunity merits the investment.

So what does the Risk Management Products Structuring team do for Global WMBB? "The team helps us structure vehicles – mainly for regulatory and tax considerations – that can be widely distributed and made accessible to many clients in multiple locations," says Borutta. Structured products can also provide greater liquidity for investors, as well as reducing the heavy burden of documentation involved when investing directly in hedge funds.

The focus for European clients is very much weighted towards funds of hedge funds and structured products. Advising Swiss clients to invest in single managers is not possible under Swiss regulation if the fund is not Swiss registered. Consequently, the exposure of Swiss clients to single managers is relatively limited and is effected on a reverse enquiry basis. Borutta also points out that the more conservative nature of the client base means that funds of hedge funds and structured products are generally preferred as a less risky means of accessing hedge funds.

"It is almost inevitable that UK private investors will have friends who are hedge fund managers and have a natural interest in them. And of course people always prefer to invest with those that they know and trust"

Investing in single managers

The regulator in the UK, the Financial Services Authority (FSA), takes a more pragmatic view toward hedge funds. As a result, a distinct business was set up in 2000 by Bell to tap the increasing interest in hedge funds from private investors. "In the UK, there is a growing and indeed very strong culture around hedge funds. After New York, London is the second largest centre of hedge fund excellence and is growing at a healthy pace. It is almost inevitable that UK private investors will have friends who are hedge fund managers, and therefore have a natural interest in them. And of course people always prefer to invest with those that they know and trust. From a regulatory perspective, the position is quite interesting. The FSA prohibits the marketing or promotion of unregulated investments unless firms take the necessary steps to ensure that such investments are suitable. In other words, hedge funds cannot be marketed or promoted to prospective investors, but following the UBS account opening and risk-profiling processes it becomes clear in establishing their suitability in a client portfolio."

Bell goes on to explain: "We didn't have a UK onshore private client business in London before 2000. The launch of the business was part of the 'European Wealth Management Initiative', whereby we launched onshore businesses virtually simultaneously in five major European countries. We had strong investment banking and derivatives expertise and as a result, our initial business was built around the tax-efficient monetisation of the shareholdings of wealthy entrepreneurs who had sold their business and were paid in the stock of the acquiring company over which they had no control. Effectively we took them out of their high risk equity positions and converted them to cash. Given that we were in a falling market from April 2000, it was only natural that these hugely wealthy investors turned to hedge funds rather than equities, as capital preservation was high on their agenda."

Private clients' risk/reward expectations of hedge funds

Asked about clients' expectations of the risk reward profile of hedge funds, Borutta believes that expectations are always connected to the risk free rate. "Over the last few years, 5-8% p.a. was a rough guide to what were realistic expectations of return for fund of hedge funds. But of course the US risk free rate has moved from 2.5% to 4.75% over the last 18 months. So a fair return should now be around 8-10%. Obviously, returns on single managers can be higher but clearly at the price of higher risks. Even with our more conservative clientele, expectations have risen recently – and that is not a judgement but a concrete observation." What worries Borutta and Bell most, of course, is the risk involved to generate such returns. As Borutta puts it:

"I don't think anyone in the business would assume that because empirically fund of hedge funds have exhibited 2.5-3% volatility for a while that this is a true reflection of the risks involved in being exposed to hedge funds. There is always the risk that a hedge fund within such a fund of hedge funds can have a performance 'problem' or even be involved in a scandal. Of course, our due diligence process tries to minimise such risks. If there is unexpected volatility from a manager, the impact on a properly diversified portfolio should still be quite small."

Bell believes that hedge funds are for the most part less volatile today than they were in the 1990s. "In the 1990s, managers were generally more levered and the industry was dominated by the inherently more volatile global macro strategies. Since the advent of fund of hedge funds and more institutional type investors, managers have tuned down their risk in order to keep their client base stable as these investors are more sensitive to volatility." That said and ironically, Bell goes on to say that clients were increasingly frustrated over the course of 2003-2005 that hedge funds were actually not running enough risk – inevitably investors wish to participate more in a rising market.

"I don't think anyone in the business would assume that because empirically fund of hedge funds have exhibited 2.5-3% volatility for a while that this is a true reflection of the risks involved"

Evolution of the hedge fund industry

So how do they see the evolution of the industry? Borrutta is of the opinion that the industry will become more and more mainstream. There will be a convergence of traditional and alternative asset management with existing traditional asset management firms offering standardised hedge fund products. At the same time there will also be hedge fund boutiques evolving into large asset management firms. As Bell points out, "the traditional hedge fund is inherently unstable, and we have seen funds such as Tiger and Soros suffer as they grew very large. The main difference now is that hedge funds are evolving into more diversified asset management firms, with multiple underlying funds but often with differing business models. Examples are firms such as Highbridge, FrontPoint, Lansdowne, BlueCrest and TCI , who offer more and more hedge fund strategies either as individual funds under one roof, or as part of a common platform. These firms can hire high quality talent, not just because they have the financial muscle, but also because they provide an institutional quality infrastructure that allows the portfolio managers to focus on what they do best – namely making money. For such fund managers, it is a low risk opportunity to get into the hedge fund space without the headache of regulatory registration, real estate, systems infrastructure and asset raising." Borutta and Bell add that the industry is still thriving with entrepreneurialism, with managers setting up niche firms wherever they find opportunities for excess return. The growth of hedge funds in Asia comes as no surprise; similarly hedge funds are moving into areas such as natural resources and private equity.

Borutta and Bell are also convinced that one of the most interesting areas of development will be absolute return focused long only products. Bell says, "it's very obvious that the constraint for equity hedge funds in terms of growth is the short side of the portfolio – not just from liquidity in terms of crowded shorts, but also from takeover risk. One natural way to extend the business, and to cater for investors with a higher risk profile, is to offer the long side of the portfolio on a discrete basis."

Convergence of hedge fund and private equity – the impact on private clients

Another recent development in the industry is the convergence of the hedge fund and private equity spaces. How does this impact the portfolios of private clients? And how do the clients view this convergence? Borutta agrees that hedge funds have been under pressure to generate alpha leading them increasingly into less liquid positions. "But it is difficult to see right now how Global WMBB will exploit the opportunity from this convergence. Our clients have not yet bought in to the idea to invest in a hedge fund with a five year lock-up that is not as transparent as a private equity vehicle. Liquidity is still important for our clients," he says.

"For my part," explains Bell, "I don't think hedge funds in general have yet proved that they can operate effectively in the private equity space, although there are several funds where the less liquid portion of their portfolios have performed particularly well, often combined with a degree of activism. Hedge funds do have certain advantages over private equity firms; for example they can operate in any part of the capital structure, do not normally feel the need to pay a premium for control, and can be more flexible in timing their exit through the use of proxy hedges. There are other advantages for investors in that the liquidity is considerably better than the closed-ended structure of private equity funds, while the cash can be put to effective use within the liquid portion of the hedge fund when not tied up in an illiquid investment."

Concerns regarding the industry

So what concerns, if any, do Borutta and Bell have about the industry? "For me," says Borutta, "it is the desperate search for alpha that is potentially leading managers to take on more and more risk. We have seen a recent development into so called 'alternatives to alternatives', such as insurance-linked securities or CAT bonds. I am not sure all the risks are understood or what will happen in disaster scenarios." For Bell, it is the potential mismatch in liquidity between the terms that hedge funds offer their investors versus the underlying investments themselves. "That aside, there is nothing in particular that is keeping me awake at night, at least at the moment. I do not think leverage is excessive. Indeed, certain events in 2005 gave one reason for comfort. For example, the major sell-off in convertible bonds that we witnessed in mid-May last year was extraordinary. It was as though one day there was no bid and the next day there was no offer. It really showed how efficient the market has become and how it has developed good mechanisms to protect itself from a meltdown. Unfortunately, the flip side of this efficiency is that there are fewer opportunities to make money as a result. Of course, we should never be complacent and we must be ever vigilant and careful. We, after all, bear the responsibility of managing other people's money."

"The market has developed good mechanisms to protect itself from a meltdown"

Hansjoerg Borutta
Global Head of Investment Solutions Hedge Funds, Global Wealth Management & Business Banking, Zurich

Hansjoerg Borutta has been with UBS since 1994. He is member of the management committee of Investment Solutions, chairman of the IS Hedge Fund Investment Committee and member of various other IS investment committees. Hansjoerg has a background in quantitative research, asset allocation and product development and has worked in UBS's Global Wealth Management & Business Banking and Global Asset Management business groups. Accomplishments include his successful product design and due diligence process for the UBS Managed Fund Portfolio programme within Investment Solutions. Before UBS, Hansjoerg worked for several years as Senior Economist at Oxford Economic Forecasting and BAK Basel Economics. Hansjoerg holds a degree in Economics from the University of Freiburg, Germany, and a doctorate in Econometrics from the University of Bern, summa cum laude.

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Tim Bell
Head of Alternative Investments, Global Wealth Management & Business Banking, UK

Tim Bell has been with UBS since 1999. He has a background in emerging markets debt trading and corporate finance from Lazard, which he joined in 1984. In 1992 he moved to J.P. Morgan where he was a Vice President and instrumental in the establishment of their London private banking business. At UBS he established the alternative investment business in London which has been an important element of the successful growth of UBS Global Wealth Management & Business Banking in the UK. In his role he has responsibility for all aspects of the hedge fund business from sourcing, due diligence and monitoring of hedge funds, to advising clients with complex investment needs in hedge funds. Tim holds an honours degree from the University of Durham.

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An institutional provider's view


Dr Ulrich Keller

Originally established to manage the UBS Pension Fund's alternative assets, the Alternative Funds Advisory group's mandate was to allocate to hedge funds as well as private equity and non-traditional real estate. The team's investment strategy was highly successful and other institutional clients soon wanted to join the model, typically requesting that an individually managed account be set up for their assets. Alternative Funds Advisory (AFA) now manages portfolios for a broad base of institutional clients with an asset value of almost US$6 billion. AFA's Chief Investment Officer, Dr Ulrich Keller, talks about this key multi-manager provider within UBS Alternative & Quantitative Investments.

The origin of your business has given you a unique positioning; AFA is closely aligned with the institutional clientele you represent. How do you differentiate yourself from other fund of funds?
We are large enough to be a meaningful player, yet small enough to move opportunistically and invest in managers with small but high quality capacity in certain niche areas. Our ability to provide customized solutions gives us great flexibility not only in terms of portfolio structure (as evidenced by going as far as integrating hedge fund and private equity investments), but also in terms of delivering information, know-how and investment and risk reporting tailored to meet client needs. This flexibility and degree of individual attention provides an additional comfort level to many top-tier institutional investors and is a key differentiating factor. Our people also set us apart; we took great care to assemble a high-calibre team of investment professionals with dedicated experience in their area of competence. Our current team comprises 42 investment professionals, who have all worked in similar research or trading environments before, and who cover all strategies. Yet, despite our extensive resources, we still aim to control the number of funds in which we invest, as we firmly believe that a more concentrated product has a better chance of delivering on our clients' goal – to achieve superior risk-adjusted alpha. It also ensures that we leave no stone unturned in the due diligence process.

Indeed, operational risk is a very important consideration. This has always been a particular focus of our institutional clientele, so we were among the first to view operational due diligence as a separate and important research discipline. We have gone so far as to outsource part of this function to an external service provider that works exclusively for AFA on operational due diligence, which we believe strengthens our ability to generate an independent check on the organization we are working with. It is precisely this level of independent insight that our international institutional investors are seeking.

What qualities are you looking for in a manager? And how do you approach the selection process?
The manager has to have a sustainable competitive advantage in his respective field of trading and he has to be able to capitalize on that advantage. These capabilities are inevitably linked to an individual's specific background – his professional track record, training and experience. We devote substantial resources towards gaining a deep insight into a manager's background and go to great lengths when checking the references of a fund's key personnel. We then test the manager's skills through a series of interviews, discussing specific trading examples, research, risk management, and implementation. As part of this process, we challenge the manager's proposals – insisting on working out the proposed investment process ourselves – nothing is taken at face value. This very thorough approach ensures that we explore all strengths and reveal any potential weaknesses. For us, the ideal manager needs to be able to demonstrate excellent skills throughout all stages of the process within an operationally sound set-up.

There is no delineation between portfolio manager and analyst at AFA. Why have you decided to merge these roles and how does it affect the fund selection process?
We have clearly defined responsibilities on two levels: each fund is allocated to one analyst and each portfolio to one portfolio manager. Every analyst takes a fund from the initial call all the way through to the investment committee, however, each important manager call or onsite visit is attended by two analysts in order to guarantee a well-balanced assessment. Accountability for each portfolio rests with the portfolio manager (who is also an analyst). We believe there are compelling advantages in combining the two roles. When conducting research, the analyst not only renders a judgement on the manager's investment strategy, but also has a perspective on the manager within the context of the portfolio – he understands what the manager's role will be and can add that view to his assessment of the potential investment. This reflects one of our core beliefs, that a portfolio is not just a collection of good managers; it needs to be viewed and managed as a dynamic system of interacting funds. This is evidenced by the fact that in portfolio meetings the portfolio manager will very often discuss certain gaps or needs in the portfolio, which contributes to the due diligence process.

However, at the end of the day, it is the investment committee that approves every single manager and every portfolio decision. The analyst/

"…for a hedge fund portfolio to develop its full diversification potential, it should have about the same volatility as the overall asset allocation…a more concentrated product has a better chance of delivering on our clients' goals"

> "Such is the current interest in our innovative approach to managing co-mingled alternative vehicles that we are in the process of launching a product that captures our capabilities. This portfolio solution will provide exposure to hedge funds, private equity, global real estate, and commodities – all in one"

portfolio manager is responsible for presenting appropriate suggestions and preparing the necessary material, which then undergoes a detailed discussion and feedback loop until the committee and I, as Chief Investment Officer, are happy to grant approval.

Tell us about your investment philosophy; how has it been influenced by the clients you currently serve?

There's no question that working with large and demanding long-term investors – many of whom are operating in an asset liability context – has shaped us. From the very beginning it has forced us to see the clients' investments into alternatives in the context of an overall portfolio. A mere allocation to hedge funds is not sufficient for these clients. It is important to find the appropriate match between the alternative allocation and the characteristics of the rest of the portfolio. It has also been interesting to help clients in their efforts to adapt and change the alternative allocation, whenever their overall portfolio has experienced shifts.

We are seeing, and indeed support, a certain shift away from the classical low volatility model of investing into hedge funds. Many institutional investors and allocators started to navigate hedge funds by initially focusing on cash-plus type set-ups that do not carry much risk (at least in normal times) and which help stabilize the overall portfolio. We believe that for a hedge fund portfolio to develop its full diversification potential, it should have about the same volatility as the overall asset allocation. And the typical volatility of an institutional asset allocation ranges between 5% and 8%.This has led us to focus on managing risk in terms of the maximum drawdown risk. We look at the risk and magnitude of a large portfolio drawdown, the impact of the timing and, last but not least, how long it will take the portfolio to recover.

Taking account of the fact that your clients' alternative allocation is viewed in the context of their overall portfolio, what are they looking for in terms of risk and return?

We have a very diverse set of clients, in terms of size, risk tolerance, return goal and investment horizon, so it is difficult to generalize, but the expectation of absolute return on overall diversification is a common denominator. On broadly diversified portfolios we aim for a return target of US$-Libor + 4%, which is similar to rational long-term expected returns on equities. Volatility is aimed at 5% to 7% and, more importantly, maximum drawdown is targeted not to exceed volatility.

This again sets us aside from many other players. Typically, low volatility strategies (such as relative value) show a maximum drawdown that is a multiple of its volatility (e.g. the HFRI fixed income arbitrage index has an annualized volatility of 3.93% over ten years to February 2006 and a maximum drawdown of –14.42%). Obviously, this means that volatility is a bad indicator of risk in terms of the absolute dollar loss potential. In fact, AFA has termed the ratio of maximum drawdown over volatility the "risk ratio", in order to distinguish it from the well-known Sharpe ratio. In hedge fund strategies it is the same low volatile strategies that show the highest Sharpe ratio (which is generally an attractive behaviour) and the highest risk ratio (which is clearly adverse to the investor). Overall, we advise clients to watch both components of risk versus return.

Your mandates into alternatives stretch beyond hedge funds into private equity, real estate and commodities. And your team has gained a reputation for its unique approach to such co-mingled vehicles. Can you tell us more about this approach?

Yes, we're seeing an increasing tendency among institutional investors seeking an integrated investment approach to cover all these alternative asset categories and AFA is well equipped to offer such services. In late 1999 AFA was the first investment company – to our knowledge – that deliberately combined hedge funds and private equity investments. Today, we cater to a number of portfolios that constitute a blend of hedge funds, private equity, real estate and commodities. This is an exciting area for investment. But managing such co-mingled vehicles can be challenging, particularly in managing the capital call process related to private equity commitments and the directionality (beta) of real estate and commodities.

The main advantage of our approach is that it mitigates the typical J-curve of private equity investments. The J-curve is a result of initial costs and build-up expenses in a private equity portfolio and will lead to a pronounced negative performance of every private equity portfolio in the first three to four years – a fact that often prevents institutional investors from investing into private equity. Using our integrated approach we invest the un-invested capital commitments from private equity into a well-diversified hedge fund portfolio where its return helps to mitigate the J-curve effect. Indeed, our portfolios have not shown a negative year since 1999 even when the private equity part has gone through its typical J-Curve. Moreover, our approach enables each investor to be fully invested in alternative assets even for private equity, as compared to the classical approach where the un-invested commitments are typically covered by cash, which leads to a substantial dilution of return.

It is this ability to innovate that presumably is driving your growth…?

We believe that our ability to innovate, develop solutions and portfolio structures that meet the requirements and demands of our preferred partners – institutional clients like pension funds, insurance companies, treasuries, and other banks, as well as sophisticated family offices – will allow us to continue to grow at a managed pace.

Such is the current interest in our innovative approach to managing co-mingled alternative vehicles that we are in the process of launching a product that captures our capabilities. This portfolio solution will provide exposure to hedge funds, private equity, global real estate, and commodities – all in one. As these asset categories have a definite, different economic cycle, an integrated and dynamic portfolio approach leads to even better risk-adjusted alpha. It shows that even a certain (actively managed) beta exposure, in particular in commodities and real estate, supports the overall portfolio outcome. We are thrilled to be able to roll out this product in 2006.

What about future strategies, regions and opportunities – where is there most scope for performance in 2006 – and do you have any concerns about the hedge fund industry today?

Equities are of continuing interest, and we particularly like managers who have the ability to capture beta (directly or indirectly), and who truly focus on stock selection. Given the still healthy state of many companies' balance sheets and earnings, we believe that fundamentals do matter going forward and hence stock picking will be rewarded. This will be particularly true for Asia where there have been strong international flows and the market has not differentiated between stocks. Other opportunities include equity oriented event driven managers who are able to capitalise on increasing corporate activity for cash-rich companies, or on consolidation plays, although this does not necessarily extend to the classical merger arbitrage players. Within credit, we are moving away from credit arbitrage and classical high yield strategies to investing with managers who prefer flexible exposure management versus credit spread levels, and managers who show opportunistic trading behaviour.

We also favour systematic and discretionary trading strategies because synchronized policy decisions and current account imbalances will open the markets for break-outs from range-bound trading behaviour, in particular the currency and rates markets.

As regards concerns, our constant concern is that new entrants with less qualified backgrounds will migrate into this area, driven by higher fees, higher capital flows and for some, by the fashionable prestige. We also accept that striving for skilful talent is inherent to our business and that does not seem to change over the years – we are always faced with scarcity of true talent. And while we certainly welcome sensibly increased regulation we do hope that it will not deprive hedge funds of one of their key alpha generating characteristics – the freedom to capture opportunities when they arise.

> "We welcome sensibly increased regulation but hope that it will not deprive hedge funds of their key alpha generating characteristics"

Dr Ulrich Keller

Chief Investment Officer, AFA, Alternative and Quantitative Investments, Global Asset Management

Dr Ulrich Keller is the Chief Investment Officer of Alternative Funds Advisory (AFA), a key multi-manager provider within Alternative and Quantitative Investments (A&Q). He is primarily responsible for portfolio construction and investment due diligence. Ulrich oversees the selection of Private Equity and Hedge Funds for institutional clients. He manages research, strategy and trading professionals and works closely with other members of the A&Q management committee in the development and implementation of business plans.

Ulrich Keller received his PhD from the University of Freiburg, Germany and a diploma from the University of Paris, France. He is a Gödecke Research Prize laureate, which is an industry-backed award for applied research in mathematical finance, and has nine years of investment industry experience. Ulrich Keller joined the then Swiss Bank Corporation in 1997 working on quantitative risk control for derivatives portfolios and moved to his current position after re-joining UBS in 2000. Prior to re-joining UBS, he worked for Credit Suisse where he was responsible for market risk control functions for interest rates and currency derivative products.

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Innovative structuring solutions to the many challenges of investing in hedge funds

William Kennedy

Sundar Polavaram

The Risk Management Products Group in London, led by William Kennedy and the Risk Management Products Structuring Team led by Sundar Polavaram, has grown an exciting business in step with the fast-paced evolution of the hedge fund industry and now manages over US$15bn in structured products. Kennedy and Polavaram talk about how the business has evolved, the drivers of their growth and how they plan to continue to provide investors with timely and innovative solutions.

Your group started at a time when funds of hedge funds were few and far between – tell us more about your origins and the motivations behind your progress?

WK The business began following the merger between UBS and Swiss Bank Corporation, when the equity derivatives group found itself with a large number of exotic equity risks on the books. The team went in search of risks

Alternative Investment Solutions: Structured Products

Sitting within the Equities department of the Investment Bank, the Risk Management Product Group, which includes the Risk Management Product Structuring Team, acts as a distributor of fund of hedge fund products and structures to: private banks and wealth managers, institutional investors looking for non-linear and efficient alternative investment solutions, and retail distributors, where regulators are comfortable with vehicles that include fund of hedge funds as the underlying investments. The AIS group is also a wrapping agent for investors requiring access to products that meet regulatory demands with possibly better liquidity terms than funds.

The team has over US$15bn in structured products, including:

- **Delta 1 products**
- **Option structures**
- **CPPT (Constant Proportion Portfolio Technique) products**
- **Leveraged products**
- **Other exotic profiles to fund of hedge fund managers**

AIS also has the ability to wrap structures around single managers where investors specifically request such a product.
- **Delta 1 products are offered around single managers or baskets of single managers**
- **Option, CPPT and Leveraged products on basket of single managers**

and products that didn't compound the positions inherited after the merger. At the same time, we recognised that there were clients out there who weren't just looking for equity product but wanted something more diversified – something that could be provided by alternative assets. Certain transactions led us to the fund of hedge funds industry and we started building it out from there.

SP We started with a securitised investment – a global certificate linked to a fund of funds. At that time, this was something new and different in the market. People were in the single fund business but there weren't too many funds of hedge funds around. So, we looked into marketing this global certificate in Europe. This had the additional benefit of diversifying the investor base for the fund of hedge funds. A certificate around a fund of hedge funds could offer a number of synergies to European investors, not only access to a diversified portfolio of high quality single hedge funds, but also an efficient wrapper in low denominations and a currency of investors choice that could settle through Euroclear or Clearstream.

You now have over US$15bn in structured products, what do you think have been the key ingredients to this explosive growth?

"A key component to our explosive growth was our associations with 'best of breed' funds of hedge funds managers"

WK First, we got into the business quite early in terms of wrappers around funds of hedge funds. At the beginning of 2000 when the market was still flying, there were a number of clients who wanted to diversify away from their highly profitable equity exposures. Then as the market took a downturn people were looking for an alternative product to equities where they could get equity like returns with a lot less of the volatility, especially on the downside, and I think that led to the blossoming of the whole funds of hedge funds investment business. Second, Sundar's team is widely recognised as one of the best in the business in terms of creating innovative solutions.

SP The other key component to our explosive growth was our associations with 'best of breed' funds of hedge funds managers. I think the quality of the underlying managers is what differentiates UBS products from the other competing banks in the business. We've been very diligent in making sure that we have the right associations and equally expedient in making sure that we bring top notch performers onto our platform. I would also agree that our other main strength is our ability to come up with solutions that effectively meet investors' needs at any given time.

Why should investors use structured products themselves rather than go directly to hedge funds or fund of hedge funds per se?
WK Two of the biggest drivers of structured products have been the economic efficiency of the holding and the securitisation process. We've been able to provide investors with securities that meet their personal or institutional requirements better than, for example, offshore funds. The other key driver has been our ability to create products that settle like securities. This actually makes a big difference to many investors.

SP Importantly, this securitization allows the small to mid-size institutions and retail intermediaries/investors to participate in the hedge fund industry. We used to speak to the larger institutions but as hedge funds and funds of hedge funds are easily able to service them directly, we have extended our coverage to small and mid-sized institutions where the ticket sizes can be more modest. We also talk to retail intermediaries that might have end investors looking to invest. The UBS franchise acts as a hub for all these flows and offers hedge funds or funds of hedge funds one net subscription or redemption. Without this service, hedge funds or funds of hedge funds would simply not (from an administrative point of view) be able to offer these types of investors access to their funds. And we don't focus on any one jurisdiction; we're looking at a global franchise.

Historically there has been a lot of interest in capital guaranteed products. More recently, leverage certificates have become increasingly popular. What structures are currently of most interest to clients and why?

SP We offer a variety of structures. The most simple is the Delta 1 pass through access product, which enables the investor to buy a securitised version of the underlying fund in denominations of 10,000 and a currency of investor's choice. I think it has become the most popular product because of its simplicity. One of the key advantages is that the investor gets access to a security which clears through Euroclear and Clearstream and is part of a web-based trading platform that gives the investor close to instantaneous access. Most of these investors are sticky, long-term investors but providing daily liquidity gives that comfort that should they need to get out of the underlying investment they may have the ability to do so. It also clearly differentiates the investment from a direct investment in a fund of hedge funds. We also have other products, such as leverage – offering leverage in the form of options, swaps or participation certificates – and capital guaranteed products. And there are other types of products such as target redemption notes, portable alpha notes and stability notes that are customized according to investor specific interest.

One of the reasons why leverage certificates have become increasingly popular is because realised volatility in funds of hedge funds has been significantly lower than expected – more in the region of 3% rather than the expected 6-8% and obviously a fraction of the 15-25% volatility of world equity markets. As a result investors have become increasingly comfortable with the hedge fund investments and consequently comfortable leveraging their investments by as much as 2-3x. From UBS's perspective, we are of course careful to ensure that UBS's total investment and the total amount of structured products within any particular fund of hedge funds is kept within a certain limit.

WK I agree. This low volatility has led to a slight change in market demand and consequently the products that we are creating for the future. For example, we perceive an increasing demand for products around baskets of single managers and indeed around single managers. We are now able to respond to some of this demand.

In terms of growing your client base, where do you see the greatest opportunity?

SP From a regional perspective, about 80% is coming from European investors, about 7% each from the US and Japan with the balance coming from Singapore, Hong Kong and Australia. The number in the US is clearly very low and therefore represents an exciting opportunity. The US market has only begun to embrace hedge fund structured products over the past few years, while the European and Asian structured products markets have been around since the late 1990s. Fund-linked structured products represent a significant growth opportunity for domestic funds as US HNW and institutional investors continue to seek leveraged, efficient holdings or principal protected exposure to hedge funds. In percentage terms, the market may seem small, but in absolute terms we have issued about US$1 billion of fund-linked structured products in the US.

Let's talk a bit about the environment in 2005. It was a challenging year for many funds of hedge funds, particularly those with broadly diversified funds of funds. From your perspective, how are funds of hedge funds confronting the low return environment and where do they see future opportunities to generate alpha?

SP Yes, it's true that the average product is highly diversified and in a low volatility environment it is quite difficult to generate returns. Funds of hedge funds have responded to that by creating products with more concentrated portfolios or products with certain underlying themes, such as a portfolio of Japan, Asian or Emerging Market long/short managers and commodity related funds of hedge funds.

WK In addition, I think the funds of hedge funds managers recognised throughout last year that to continue with low volatility low returns is not a very attractive proposition for investors and certainly some of them reacted to that by tilting their portfolios slightly more than has been the case

"Two of the biggest drivers of structured products have been the economic efficiency of the holding and the securitisation process" in the past 5-6 years. This was probably most pronounced in the smaller fund of funds who have the ability to alter sector weighting more easily. Towards the end of the year we saw some mid-level fund of funds perform quite well as the market picked up so it really depends on size and the ability to alter allocations. There is recognition among the funds of hedge funds managers that things cannot go on as before and they have altered their portfolios accordingly.

How do you see the evolution of the hedge fund and funds of hedge funds industry over the next five years; what are their greatest opportunities and challenges?
WK Investors will undoubtedly become more sophisticated. They will also want to pay fewer fees than they're currently paying and see more bespoke solutions, especially the bigger clients. So you will see fund of funds help institutional accounts choose more concentrated portfolios and build portfolios with specific risks (such as strategy specific or thematic). They are likely to create portfolios and products for specific clients on that basis. Portable alpha will be a huge theme in the future.

SP There will be a drive towards institutionalisation of hedge fund and funds of hedge funds firms. The investors that are expected to fuel the future growth in assets – namely the endowments, foundations, pension funds, intermediaries and insurance companies are likely to further accelerate this process. For us, growth from these investors is a one-way bet over the next few years as their current allocations to hedge funds are still very low.

Historically, your business has mainly come from products around funds of hedge funds. How are you positioning yourself for the future? For example, you've said that you are now able to wrap baskets of single managers and even single managers themselves into securitized products?
SP Absolutely, in fact we're doing it right now. Again, the small to mid-size institutions require customized solutions and UBS is better placed to offer these due to our broad and deep relationships with single managers across various parts of the bank. For example, we can offer a portable alpha solution with a funds of hedge funds, a basket of single hedge funds or even a single manager itself coupled with an index overlay of the institution's choice.

WK We are positioning ourselves so that we can create more structures on concentrated baskets of single managers or single managers themselves. Other new ideas could include multi-asset type products, for example. There are a host of other options of interest to them including commodities, real estate and equities.

SP That's right, we are clearly focused on developing different or themed portfolios. There's a wide range of interesting themes that appeal to investors for different

"…we are positioning ourselves for the future so we can create more structures on concentrated baskets of single managers or single managers themselves…we are clearly focused on creating different or themed portfolios"

reasons around which you can create portfolios of say five to seven managers. We consider ourselves to be very nimble in this respect and we have some excellent relationships in place, so what really excites us about the future are the opportunities to deliver customized products that meet our clients interest in a relatively short period.

William Kennedy
Head of Risk Management Products Group, Investment Bank
William Kennedy joined the UBS Group in 1993. The majority of his career has focussed on the sales and creation of equity derivatives and related products. The clients he has been involved with are institutional clients for their own accounts and for on-sale to retail and high net worth individuals. Over the past five years the emergence of alternative investment strategies has taken on increasing importance in the equity derivative space where William and his colleagues have been heavily involved in new product innovation and distribution. William is currently head of European sales and structuring of equity derivative products based out of London. He has an MBS in Finance from University College Dublin.

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Sundar Polavaram joined UBS in 1994. He heads the Risk Management Product Structuring team which is responsible for providing structured products around hedge funds, mutual funds, commodity indices and equities, for institutional clients and retail intermediaries globally. Sundar holds an MBA from New York University, a postgraduate diploma from the Indian Institute of Management, Bangalore and an undergraduate degree from the Indian Institute of Technology, Chennai.

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