KEYNOTE SPEAKER Jonathan Lourie, Cheyne Capital

The risks, rewards, returns and impact of hedge fund investing

With the alternative asset management industry continuing to face challenges and critics from all quarters, Jonathan Lourie, co-founder, chief executive officer and chief investment officer at Cheyne Capital, used his keynote speech – which rounded off the first day of this year's summit – to make the case for hedge fund investing.

Prior to co-founding Cheyne in 2000 alongside president and director of research Stuart Fiertz, Lourie worked from 1985 at Morgan Stanley. There, both Lourie and Fiertz cut their teeth managing convertible bonds and credit for high net worth individual investors.

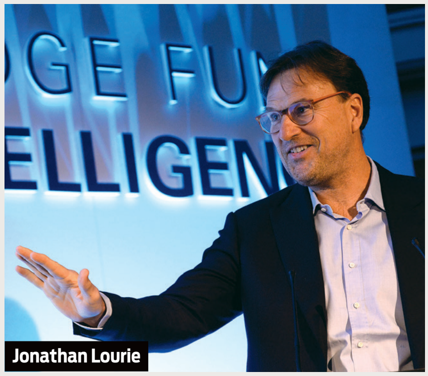
Lourie said Cheyne was "honoured" to be part of what he called the exciting growth of the hedge fund industry's prestigious "class of 2000" – market participants who had the vision to be of institutional size and to build major infrastructure from the moment they started, and which they have maintained over the past 17 years. This select group of successful hedge firms, which launched around the turn of the millennium and who went on to dominate the landscape, includes Marshall Wace, Brevan Howard, GLG, Bluecrest, Gartmore, BlueBay, Lansdowne, CQS, TCI and Henderson.

"Hedge fund investing is to a large extent path-dependent – the success of a firm is only ultimately reliant on its performance. Clearly the early participants in the European hedge fund industry are all intact thanks not only to above average performance, but more importantly delivering investors their early promise."

He observed how the industry performed successfully through the early 2000s downturn, with few hedge funds of any repute losing money during that period, while by comparison the stock market plummeted by 50% from peak to trough. He also noted how the period between 2003 and 2007, fuelled by the credit bubble, created great performance momentum for hedge funds, and considerable beta, but which ultimately led to a day of reckoning for the industry during the 2008 global financial crisis.

"An existential crisis as a systemic collapse in the banking system was inextricably linked to our industry and there was nowhere to hide," he said. "Arguably, the average hedge fund which lost 20% from October 2007 peak to trough – less than half the S&P loss – would have had its loss mitigated by more than half if the global crisis of confidence and the outright bankruptcy of Lehman Brothers had not taken place.

"At the best of times, hedge funds are not a liquid asset class, certainly not as liquid as publicly-traded equities. And yet four years of a feast of leverage and liquidity and economic



Jonathan Lourie

expansion inevitably led to a mismatch of assets and liquidity," he remarked. "As the industry entered the gold rush period, culminating in 2008, perhaps too much capital was attracted and there was insufficient capacity to handle it."

Categorising the pre and post-financial crisis periods as B.C. (Before the Crash) and A.D. (After the Disaster), Lourie said the B.C. client profile was dominated by European high net worth flows both through private banks and through funds of funds. This client base, Lourie said, proved detrimental in the liquidity mismatch.

"I'm not denying that managers, obviously, as well as investors turned a blind eye to liquidity. But when hedge funds saw this snowball gathering pace, they did what they were supposed to do – protect investors from the worst of the downside," he explained, pointing to the side-pockets, gating and restructuring that managers put in place – which were all vilified at the time, but which Lourie described as solutions to the crisis.

"When there was such a stigma around gating mechanisms, it took a brave first mover to do the right thing. What was the alternative? To give the available liquidity to investors who got their redemption requests in first, and leave all the other investors with completely illiquid assets? Or to treat all investors equally."

Lourie remarked that those market participants who survived 2008 would do everything in their power to avoid it happening again. For Cheyne, this has meant moving towards removing the mismatching of fund liquidity with investment liquidity, introducing capacity targets for its funds to protect performance, back-ended performance fees in most of its strategies, and lower fees and hurdles, among other things. At the same time, the firm also invests substantial sums of its own money into funds, and now always provides the seed capital for new fund launches, he added.

Today, one of the key drivers of Cheyne's business has its origins in the risk reward proposition that arose from the 2008 financial crisis; namely European commercial mortgage-backed securities, which were more simple to analyse than their complex US counterparts.

"Capitalising on dislocations and turbulence in an opportunistic manner is the domain which is paramount to our ethos, and hopefully to the hedge fund ethos," he observed.

He observed how hedge funds can also make a positive social contribution without sacrificing returns, a dimension he believes will become ever more important. At Cheyne, this has taken the form of its Social Property Impact Fund, which aims to deliver affordable housing across the UK to those on social housing waiting lists.

"We've stepped in because previous sources of capital have dried up. In that case, it was withdrawal of government grants for social housing in the UK. Another area is direct lending, where hedge funds are providing the loans that banks could no longer provide due to regulation, Basel III and deleveraging."

With the European banking system holding $37 trillion of assets on its balance sheets, compared with the approximately $16 trillion in the US – despite both economies being similar in same size – the withdrawal of bank liquidity and the opportunities for alternative credit, in the form of hedge funds and private equity, to replace it still has some distance to go, he added.

Building on this point, he noted strong endorsements for the hedge fund industry in many parts of the world in the face of strong scepticism – citing the UK government's Pension Protection Fund and the Japanese government pension fund, which are both investing in alternatives.

"Those parts of government that understand the cost of not generating returns are in favour. It is only populists and underinformed politicians and commentators that are pushing so hard against alternatives," he added. "Yet, according to statistics, European institutional hedge fund allocations are a fraction of their North American counterparts. At a juncture where long-term interest rates are at nosebleed-low levels, our market is totally underrepresented in European institutional portfolios."

Concluding, Lourie observed: "More than ever, investors have a chronic need for returns. Where are these returns going to come from? The passive investing bubble will not last forever, and the sizeable liquidity mismatch in ETFs risks a potential blow-up. At the same time, the bond market is dangerously illiquid and a rates-related sell-off could turn into a rout, leading to a massive increase in volatility.

"As in the past, hedge funds will be there to pick up the pieces."