



Roundtable discussion

swissHEDGE regularly invites reputed hedge funds to a discussion on their areas of expertise. For this issue, we have invited three prominent hedge funds within the fixed income space to provide insight into their respective strategies.

Eos Partners (EOS)

Fund: Eos Credit Opportunities Fund Ltd
Firm AUM: USD2.8b
Representative: Matt Meehan, Portfolio Manager

Christofferson Robb & Co (CRC)

Fund: CRC Global Structured Credit Fund
Firm AUM: USD1.5b
Representative: Andrew Leasor,
Head of Business Development

Platinum Grove Asset Management

Fund: Platinum Grove Contingent Capital Fund
Firm AUM: USD5.3b
Representative: Peter Bouyoucos, Principal

Q: Briefly describe your strategy and your main performance drivers. Have these drivers changed over time and how do you expect them to change in the future?

EOS: We are a global multi strategy credit fund, not a dedicated «distressed» fund. We take a private equity approach to credit investing and seek to achieve equity-like returns with credit-like risk and volatility. To us, this means deep due diligence and focus on downside risk and liquidity. This approach has been consistent since the inception of the strategy and leverages our private equity investing experience. The drivers of our performance are the flexibility to find opportunities in various securities such as performing and non-performing / distressed corporate and structured credits and in special situations. For corporates, we will look at the most senior to the most junior securities in a company's balance sheet. Our flexibility to invest globally in countries with established rule of law, and our dynamic use of shorting to both hedge and to generate alpha directionally, are also drivers of performance. While our geographic exposure and the securities in which we express this exposure have changed and will continue to change through time, we expect that our deep due diligence approach and focus on downside risk will remain consistent.

CRC: We invest in asset backed securities and private structured credit transactions that help European banks improve their balance sheets or their return on regulatory capital. Working with a single buyer, terms can be fine-tuned to meet the issuer's needs. We are not traders or arbitrageurs but rather, buy-and-hold investors. Our investment process relies on understanding the underlying obligations; small and medium enterprise loans, residential mortgages, commercial leases, or other loans on a bank's balance sheet, and building in structural features that protect us. Over the long run, our performance depends on whether we have done a careful job with origination, asset selection, structuring and hedging. In the short term, we are subject to mark to market due to general credit conditions. Fortunately for us, over the summer and fall, our credit hedges offset the negative marks. PLATINUM GROVE: We earn returns by reacting to opportunities to intermediate supply and demand imbalances in the global capital markets with a focus on developed government fixed-income markets in Europe, United States and Japan. While substitution results in securities with similar risk and return characteristics being priced to earn similar returns, flows caused by

the differing preferences of clienteles in the market will temporarily cause prices to deviate from equilibrium values. We profit by adding to our positions as price deviations increase and reducing them as they return to equilibrium. We intermediate only if we can hedge factor risks and still expect to earn a reasonable return on the capital employed. These convergence trades are complemented by equity strategies that add returns when markets are relatively less volatile.

Q: What to you would be an unfavorable market environment for your strategy and why?

EOS: Times of extreme optimism resulting in tight credit spreads and mispricing of risk are our least favorable market environments. An example of this was much of 2006. Long investing presents a challenge to any credit investor if spreads are at levels which are much tighter than historical averages. In markets like these, we will be extremely conservative in our long exposures and maintain an active short book. A recessionary environment would also present a challenge, as it would for investors in most financial assets. Ultimately, we should see our best investment opportunities coming out of a recession, but the challenge is to avoid investing too early.

CRC: The first half of 2007 was difficult for us. Spreads were tight, banks were reluctant to sell assets, and we couldn't find much we wanted to buy. Since our portfolio throws off cash from interest and principal payments, we were considering paying a dividend to investors and shrinking the fund.

PLATINUM GROVE: Because different clienteles are more likely to change their holdings of securities in differing ways with changes in expectations, the demand for our services is greater with greater volatility or shocks. Some of our fixed-income strategies will tend to converge and new opportunities will arise as a result. Generally, with less volatility, it takes longer for strategies to converge and the costs to carry these positions increase as the capital employed is not as productive. To mitigate these adverse carry costs, equity strategies, such as merger-arbitrage and stock-volatility, provide carry returns to us.

Q: How do you differentiate yourself from your peer group?

EOS: First, our private equity experience, which includes sitting on boards and managing businesses, is a differentiating factor. Secondly, our principals and sponsors

are significant investors in the fund, which aligns our risk with our investors' risk. Third, the fund uses little or no leverage and is a true credit fund (meaning that we have had no style drift to equities). Fourth, we have very strong co – investing relationship with some of the largest European credit special situations groups and this, we believe, has allowed us to create a relatively unique portfolio, with little overlap with our peers. Finally, our hedging strategy combines a top down macroeconomic approach with bottom up company analysis and has been a successful way to both protect our downside risks and generate alpha for the fund.

CRC: As far as we know, we don't have a peer group pursuing our strategy. We are not sure many people would want to do it: it's operationally intensive, deals can take years to negotiate and sometimes they don't end up happening at all. A certain scale is required to make this strategy efficient, so starting up is risky. It's not wildly profitable even in the best of times.

PLATINUM GROVE: We employ a disciplined and systematized approach to the capital allocation process by combining a bottom up with a top down approach to capital allocation and risk management. Capital is allocated dynamically to competing teams. Each team implements their approved strategies, conducts research to enhance current and develop new strategies. We have built a proprietary scaling technology to indicate to each team how to add to and reduce positioning. The capital allocation committee (through the independent risk control officer) allocates the capital necessary to sustain each of the strategies as if each was a stand alone business. In addition to working capital necessary to support a particular strategy, unlike others, we do not rely on correlations to determine risk capital; instead, we use the capital necessary to sustain a strategy through stressful times. This means that the expected returns on strategies are correctly computed to handle all anticipated contingencies. The expected returns are combined through an optimization process and a set of scenario analyses to determine the overall level of the risk budget to employ and how much of the risk budget to allocate to each strategy.

Q: What is your view on the use of leverage - in general and for your strategy?

EOS: We believe that the best time for a credit fund to be levered (if ever) is at the bottom of the credit cycle when leverage is difficult or impossible to attain.

We generally do not use any leverage, but maintain the ability to do so in times of extreme market dislocation. It is our philosophy that by limiting leverage during normal market conditions, we are in a better position to aggressively look for opportunities when markets are in turmoil.

CRC: We are happy to take all the leverage that is available to us, provided that it is genuine long-term funding. We do not fund assets that are illiquid or potentially illiquid with short term repo. We had this view before term funding was cool.

PLATINUM GROVE: Leverage in our fund results from the risk management process and the nature of particular strategies employed. If the opportunity set is diversified to shock we will use more of the risk budget. As a result, we will tend to use more leverage. Since we do not earn returns by taking factor exposures or directional risk, we need to hedge these factor risks. Hedging to reduce risk actually increases leverage. Once we have reduced risk we use leverage to increase risk to intermediate the market imbalances given the allocations suggested by the optimization and risk scenario process.

Q: Have innovations in structured credit increased or decreased systemic risk globally?

EOS: These innovations have dispersed risk but this dispersion has placed misunderstood risks in the portfolios of uneducated investors. In other words, there is an unequal balance of educated buyers and sellers, favoring the sellers. For example, in the chase for yield, many money market funds have exposed themselves to risks that they misunderstood and investors in these funds have unsuspectingly been exposed to the risks created by financial innovation.

CRC: We believe (although we can't prove it) that structured credit innovations have done a lot to dampen business cycles and thereby reduced global systemic risk. The obvious contribution of structured credit is in spreading risk to institutions that can readily absorb shocks, leaving banks in better shape during a downturn. A less appreciated macroeconomic contribution is the CLO boom that facilitated leveraged buyouts. Evidence suggests that private equity sponsors can rehabilitate struggling firms more effectively than public companies; newly private firms can more easily cut costs or radically shift their strategy and are more likely to survive and prosper during a recession.

PLATINUM GROVE: Innovation in general is the life blood of the financial markets. Capital market partici-

pants innovate to reduce frictions and satisfy customer needs. Presumably, credit innovations helped spread credit risks broadly allowing for greater use of these risk reducing and risk spread technologies. After the fact many innovations succeed and others fail. Structured credit will likely survive the current crisis maybe at a smaller scale, with more controls, and in improved and stronger forms. Most innovation runs ahead of the infrastructure to support it. As a product becomes more standard form, infrastructure catches up and institutionalizes the product. In the recent case of credit, difficulties occurred prior to the institutionalization process catching up. As new infrastructure is built and the uses are better understood, the likelihood of systemic difficulties are reduced.

Q: How has the recent liquidity crisis affected your strategy, and how do you expect the situation to resolve?

EOS: The repricing of risk has presented attractive investment opportunities in specific credits which we own and some which have been on our watch list. We remain cautious, defensive and hedged and we look to take advantage of sell-offs by adding incrementally to our long book. We believe that the repricing of risk has yet to be fully played out. The market is currently in «price discovery» mode, as banks deal with the challenges of marking the investments on their balance sheets to market. Ultimately, the market will clear as buyers and sellers reach equilibrium. If the Fed cuts aggressively such that the Fed Funds rate trades on parity or below the 3 Month Treasury Bill, the resolution could be sooner than many people predict, as banks will be able to rebuild capital more quickly. The US housing market and consumers may take two to three years to recover as the «echo baby boomers» grow household formations and the consumer rebuilds his balance sheet.

CRC: Even though the manager of a «global structured credit fund» might be expected to suffer heavy losses, the liquidity crisis has affected us very little. It helped that we do not invest in subprime RMBS, ABS CDOs or similar products structured by dealers. We continue to work with European banks to prepare their balance sheets for BIS II. Of course, pricing has become more favorable for us on new deals. Term financing is more scarce than before, so we have a tougher time buying mezzanine or investment grade assets that require leverage. I personally think the liquidity crisis will be largely resolved by the time this issue of swissHEDGE goes to print

(note by the editor: February 2008). ABCP conduits have unwound, central banks are flooding banks with liquidity, and investors have taken their losses in subprime and structured finance.

PLATINUM GROVE: Since fixed-income intermediation strategies generally benefit from elevated volatility, the outlook for our fixed-income strategies is extremely positive. Not so for our equity strategies. As a result, the capital allocation process has allocated capital more so to fixed-income and less so to equity strategies. We expect this to continue through 2008 until the liquidity crisis is resolved.

Q: What are your expectations about continuing developments in the breadth and depth of the fixed income markets outside of the US?

EOS: The market for emerging market corporate debt will only develop if the rule of law in emerging market countries improves and creditors know that contracts will be upheld. In many cases, Europe is still not there, so we are afraid that emerging markets generally have a long way to go

CRC: European ABS issuance has grown from USD31b in 1996 to over USD550b in 2006, but it still has a long way to go to catch up to the US. In 2006, US ABS issuance was about USD1.9 trillion plus USD905b in agency residential mortgage backed securities. European markets are particularly underdeveloped for credit card loans, student loans and residential mortgages in countries other than the UK, Netherlands, Denmark and Spain. In 1980, mortgage debt to GDP was 35% in the US. Now it is 70%. Among European countries, only the Netherlands, UK, and Denmark have mortgage markets that are as large relative to GDP as the US. Mortgage debt to GDP in Italy, Austria, Greece and France are all under 25%. These countries now lag behind Estonia (32.4% in 2006 vs. 15.9% in 2004) and Latvia (28.9% in 2006 vs. 11.8% in 2004). We are confident that most of Europe will continue to bring consumers increasingly efficient access to mortgage credit. But many things need to happen first. These include further improvements in bankruptcy law, mortgage enforcement procedures, credit bureaus and laws that promote securitization.

PLATINUM GROVE: Although we have concentrated our risks in the G7 fixed-income markets, we expect over the next number of years that we will have opportunities to intermediate imbalances in the developing

less-developed markets such as China and India. As mentioned early, we need the ability to hedge factor risks before providing our services. Although these markets do not currently have hedging instruments we expect that they will develop in the years ahead.

Q: Looking back, what are the lessons of 2007?

EOS: Both a glut of liquidity and a glut of credit pushed market professionals across the credit spectrum to overreach for performance. The dispersion of risk showed up in unexpected places. The irony in all of this is that it turned out that hedge funds may have marked their investments more accurately than regulated financial institutions!

CRC: The US subprime crisis is only one aspect of a broader, parallel boom and bust in quantitative structured finance. As rating agencies pushed models further and further, the world's most conservative money market investors ended up holding asset-backed commercial paper that hinged on bizarre, simplistic models. These models lack empirical or theoretical content. The longer the boom lasted, the more rating agencies trumpeted the stability of structured finance compared to corporate credit, the more investors learned to rely uncritically on ratings. When market participants rely on fixed rules, others modify their behavior so that the rules stop working. For example, homebuyers learned to manipulate their FICO scores. Brokers learned the income and job status requirements necessary to get stated doc loans approved, so-called «liar loans.» Investment bankers learned how to exploit flaws in rating agency models that treated triple-B tranches from different issuers as if they were nearly independent.

PLATINUM GROVE: For us, discipline is key. 2007 reinforced our view that to trust but verify is the key to running our business successfully. We believe strongly that portfolio management and risk management are intertwined. With the ability to measure and monitor risks, we attain a richer understanding and an ability to take on additional risks. With new strategies and opportunities, 2007 reinforced our belief that without well-defined infrastructure such as the risk-management process, the risks should be kept small. Our use of stress risk prevented us from targeting volatility. We targeted expected return on stress capital. This kept our risks in check and under control during the difficult period.

Q: What market or economic developments pose the

biggest risks to your strategy in 2008 and where do you see most opportunities?

EOS: A recession, as mentioned earlier, will create both the greatest risks and opportunities for our strategy. We are cautious about buying too early in a recession, waiting for clear signs that the economy is bottoming before we go long. We would attempt to mitigate this risk with our directional short book and by continuing to be conservative on the long side of our portfolio. The good news is that a recession would likely accelerate the default cycle. While timing bottoms is always a challenge, buying credit at the bottom of an economic cycle created the outsized distressed returns of the early 1980's, 1990's and 2000's.

CRC: European banks using the Advanced Internal Ratings Base Approach adopted BIS II starting in January 2007. This overhauls the way banks measure the impact of securitization on the amount of regulatory capital they need to hold. In the new capital regime, a bank can buy protection on the first 3% of a pool of loans and cut the risk weight by a factor of three. Under BIS I, a bank had to hedge the entire capital structure to obtain significant capital relief. Other opportunities for our strategy will arise from consolidation of European banks which is not yet finished.

PLATINUM GROVE: The biggest risks for us are that opportunities become too good. At these times, it is difficult for us to calibrate and rely on our models. At the extremes, the flows in the market might overwhelm the forces of substitution that make markets work. At these times, we reduce risk giving up the opportunity to earn returns until we are able to recalibrate our models, garner enough information to assess the situation and regain the confidence that we are able to intermediate once again. Our goal is to preserve investor capital and earn returns once we understand the opportunity to intermediate in the market.

Q: Why should institutional investors, with long-only exposure, shift capital allocations to your specific strategy in this business cycle?

EOS: Our active short exposure and diligence - driven private equity like approach should continue to generate equity like returns with debt like risk and reduced volatility. For long only investors, this should provide uncorrelated returns and give them exposure to a strategy that will eventually aggressively invest in the attractive investment opportunities that will be created by the next

default cycle. The unfortunate truth is that long only investors are exposed to the deterioration of the credit markets as this economic cycle approaches a bottom.

CRC: Institutional investors should not allocate to gain exposure to European structured credit. Rather, investors should decide based on the details of how well the manager carries out its tasks. Funds that invest in complex securities must contend with factors that are unquantifiable and ambiguous and so require the manager to apply judgment. Investors can only evaluate the manager's capabilities by engaging in due diligence for themselves.

PLATINUM GROVE: We are a money-market substitute. We provide returns in excess of money-market returns without taking directional market exposures. With greater risk aversion and market turmoil, holding a fund that exhibits no correlation with market indices is a appealing to many investors.



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