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Looking Ahead to 2012: The Hedge Fund Industry Speaks (Part III)

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Nobody can say for sure what lies ahead, but *FINalternatives* Senior Reporter Mary Campbell asked some industry experts to give us their best guess as to what 2012 will bring for markets generally—and hedge funds in particular. Here's what they had to say (Part III of III).

Deepak GurnaniDeepak Gurnani
Head of Hedge Funds, Investcorp

We expect further pain and deteriorating economic fundamentals over the next 12 months, stemming mostly from Europe's flawed austerity plan and the failure of its leaders to address the regional sovereign debt crisis. European banks remain inadequately capitalized, and recapitalization of many is inevitable.

Hedge funds, nonetheless, should find opportunities to put capital to work for investors. We see three attractive opportunities for 2012: shorting major EU sovereign debt, namely Italian, Spanish, French and German debt through credit default swaps; shorting the European Financials Credit Index (iTraxx Financials senior and subordinate); [and] shorting select emerging market debt, particularly Russia, through CDS.

An important 2012 activity will be to plan how best to position the portfolio for the conditions we expect to prevail when the current turmoil subsides. Once European leaders realize the flaws in their current approach, we expect they will pursue a combination of sovereign debt restructurings, exits from the euro zone and debt monetization, i.e., printing money. As this scenario plays out, we will look for positions in high quality US and European large cap equities, some of which are trading at generational lows. We would also favor distressed and restructured debt and equity in the United States and Europe.

Lisa CorveseLisa Corvese
Managing Director of Global Business Strategy, PerTrac

It is now time for all investors to understand how to properly assess portfolio risk by reading the third and fourth "moments" of a return distribution (skewness and kurtosis) along with mean and variance in order to achieve positive performance return through better portfolio construction. Managing exposure in 2012 will require anyone allocating capital to use risk measures beyond normal distribution analysis to properly assess expected gain, expected loss and to really "see" the correlation of assets within and across their portfolios. In the quest for Alpha more investors will allocate more capital to alternatives. Alternative investing will continue to become more mainstream, converging with other choices offered by RICS and UCITS. High volatility will also drive allocators to keep a sharp eye on managing the liquidity of their portfolio.


Stuart Parfitt**Stuart Parfitt**
Investment Director, Business Lending Secured Income Fund

Investing in house building requires a certain degree of crystal ball-gazing due to the fact that you are aiming to deliver a product to the market from 9-18 months hence. Having funded residential developers for over 20 years, I have learned to quite the current market noise and focus on fundamentals. So whilst the Euro debt crises and low economic growth prospects dominate the headlines and will likely do so for some months yet, the BLSI Fund investment team will be focusing on those fundamentals; we simply are not building enough new homes in and around London to fulfill the demand.

At Business Lending we view Q1 and Q2 2012 as critical periods to invest in house building for delivery at the end of 2012 and the first half of 2013. Land values are currently restrained and with no pressure on building labor or material costs, execution and development risk is moderated. By investing in highly experienced developer counterparties and building in the high demand areas in and around London, the sales risk can be better managed.

In the UK, we are going to lose a bit of time for our Queen's Diamond Jubilee in June and then the Olympics. So to deliver our target product into the market in Q4 and 2013 we need to work hard with our investor and developer partners January through July. Then in August hopefully the only judgment call I need to make is which of the Browning brothers will win the Triathlon Gold Medal! Happy New Year.


Jeff Peskind**Jeff Peskind**
Founder and CIO, Phoenix Investment Advisors

U.S. high yield looks to be a compelling asset class looking out to 2012. Given the macroeconomic uncertainty and fears surrounding Europe, many high yield bonds have fallen significantly in price over the past few months. Despite all the headline risks, U.S. corporate
fundamentals are in good shape. Companies are sitting on cash, de-leveraging their balance sheets and pushing out maturities. Most default rate forecasters expect 2-3% default rates in 2012 (which is below the

historical average of 5%) and high yield spreads are now around 750, meaning investors are getting substantially more yield in high yield bonds than they should need to compensate them for default risk.

Filippo Pignatti Morano di Custoza
Manager, The Classic Car Fund

The euro-area debt crisis, which has triggered the downfall of political leaders in Ireland, Portugal, Greece, Spain and Italy, has not boosted investor confidence. Any weakening in growth will reduce government revenue and hurt public finances, indicating further austerity measures, further stunting growth. As a result, the Custoza family office expects to see a further increase in investors searching for tangible assets, such as precious metals, art and classic cars.


Andrew RubioAndrew Rubio
CEO, Throgmorton UK

Following the recent UK launches of fund managers such as Saba Capital and Loomis, Sayles & Company, we believe U.S. alternative fund managers will continue to set up new offices in Europe in 2012, with a specific focus on London. Reasons behind this include a desire to establish a presence at the request of their investors, the opportunity to trade over a longer day, access to European institutional investors and better research capabilities for investments in European companies. Furthermore, the sovereign debt crisis has caused extremely high market volatility creating a diverse range of investment opportunities for alternative fund managers. London will continue to be attractive due to the capital’s ability to bring in investors and professional talent, as well as its vibrant lifestyle.

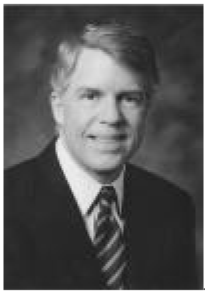

Parag SaxenaParag Saxena
Founding General Partner & CEO, New Silk Route

I believe that the Indian consumer sector, particularly retailing and restaurants, will continue to do well in 2012 driven by the overall increase in population wealth. Interest rates have peaked and we should start seeing lower interest rates towards the end of next year. That will positively impact Indian financial institutions. Additionally, as people recognize that European turmoil will only have a modest impact in India, I expect the rupee to strengthen by at least 5% from its current level (Rs. 53.30/$1). Finally, I am optimistic that 2012 will also see positive rule changes and increased transparency surrounding India’s infrastructure and government procurement processes. This will benefit companies involved in the bidding process and overall competition in India in general.

**Humayun Shahryar****Humayun Shahryar**
Founder and CEO, Auvest Capital Management

While the world focuses on the problems in Europe it is the emerging markets that will make headlines in 2012 as we begin to see the BRIC countries tumble. European leaders are now openly acknowledging the issues in the Eurozone and are making slow progress towards a resolution, with recent policy actions by the ECB and other central banks (swap lines, rate cuts, LTRO, etc.) providing some breathing space. On the other hand, the problems in emerging markets—which include high inflation, trade imbalances, currency manipulation, property bubbles and social discontent—are not seen as being of the same severity as those in Europe. Markets are underestimating the dependence of emerging markets on the developed world and are again taken up by the de-coupling illusion. Those that fail to acknowledge this will pay the price.

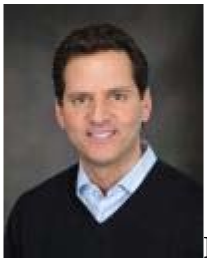
The year ahead will again see macro dominate the micro, with high volatility and wild mood swings as markets try to ascertain the direction of the global economy. Correlations between asset classes will remain high and hedge fund strategies that take a macro approach and capture volatility will come out on top. Capital preservation will be crucial and investors should avoid strategies that employ high leverage or invest in illiquid assets.

**Alan Snyder****Alan Snyder**
Founder and Managing Partner, Shinnecock Partners

"Hunkered down amidst the turmoil" best describes the prudent strategy for these markets. With broadly disparate views, markets have seesawed wildly intra-day, intra-month and between months. Amazingly, each of these comments applies to almost every market.

Non-correlated investments with hedged positions can provide reasonable returns, albeit less than in the past, plus that vital ingredient: peace of mind. With U.S. interest rates near zero, stagflation a non-trivial risk, uncertain economies and political gridlock, only aggressive investors will bet on a single direction. Even high-grade bonds, which have performed well in recent years, have asymmetrical and negative risks going forward, unless held until maturity. In short, "superdiversification" may just be the reliable turtle that will win the race through steady compounding of modest returns, until the future is clearer after U.S. elections, European action and economic stabilization.

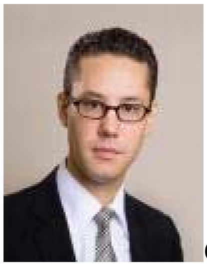
Managed futures have historically provided a shock absorber in times of extreme stress. Moreover, with generally low correlation to equity markets, they can provide a balancing return stream to traditionally diversified portfolios. As government interventions abate or become more transparent, there should be reduced "risk-on, risk-off" trading. As a result, clearer trends and fundamental supply and demand patterns may emerge in 2012, creating an environment that is favorable for managed futures.


Ron SuberRon Suber
Senior Partner, Merlin Securities

2012 guarantees to bring us material changes from the top, middle and bottom of the prime brokerage and hedge fund landscape. Shifts will include two very large banks entering the prime brokerage arena, given their need to cross sell services to hedge funds; continued merger of the mini-primes to survive; and a final exodus of hedge funds from small, self-clearing prime brokers with principal/proprietary trading desks. Many hedge funds with low or negative performance can no longer afford third-party technology expenses and investor due diligence teams look to irradicate manual processes and spreadsheets from hedge funds' daily life. The need for even more detailed analytics regarding exposure, leverage, relative/absolute attribution, stock selection, beta- and delta-adjusted risk reaches an all-time high. Investors increase pressure on funds to have best-of-breed multi-prime custodians, treasury finance optimization and business process automation.


Don SteinbruggeDon Steinbrugge
Managing Partner, Agecroft Partners

2012 will see a significant increase in asset flows to small and mid-sized mangers. This greater focus on smaller, more nimble managers has continued to gain momentum as some of the largest hedge funds have experienced very poor performance in 2011. This is good news for small and mid-sized hedge fund managers that represent a majority of the firms in the industry. Unfortunately for many of these managers, they will not participate in these flows because, unlike before 2008, a vast majority of flows are going to those small and mid-sized managers that have developed the strongest brands.


Christopher TsaiChristopher Tsai
President & CIO, Tsai Capital Corporation

Unless the European liquidity ¬and solvency issues are resolved, markets will remain exceptionally volatile in 2012, and the correlation between most asset classes unusually high. If the issues are not resolved, markets will decline meaningfully. However, governments would once again react by offering additional "solutions." Any sell-off will therefore be followed by a rally. Tsai Capital's outlook represents a dangerous situation for short sellers, and for long participants who are short-term oriented. At the same time, in 2012, the market will likely provide exceptional opportunities for investors with dry powder and a multi-year time horizon.

**Lord Andrew Turnbull****Lord Andrew Turnbull**
Chairman, BH Global

In a world of constrained political power, markets will be driven by the actions (and inactions) of politicians rather than economic fundamentals. For instance, the U.S. has a strong economy marred by a dysfunctional political system. The supposed 'most powerful man in the world' cannot get his own budget agreed and is held responsible for an economic program largely put together by Congress. In Europe, the need for consent among the countries in the Eurozone means governments cannot come up with a clear view and act on it. Week by week we see hopes rise ahead of a forthcoming EU meeting, only to crash afterwards as hopes are disappointed. Our present-day political processes aren't functioning normally, creating a surprising amount of risk and downside for markets and investors. In such a world, authoritarian regimes such as China have a comparative advantage, but only so long as they deliver rising living standards. Where they produce neither freedom nor prosperity, as in the Arab world, they will be swept aside.

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