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GENERAL EMPLOYEE RETIREMENT BOARD SPECIAL MEETING
THURSDAY, OCTOBER 16, 2003, 9:00 A.M.

I CALL TO ORDER

The special meeting of the General Employees Retirement Board of Trustees was called to order by Chairman James McC. Wearn at 9:30 a.m., October 16, 2003 in the South Palm Beach Fire Station. Attending were Chairman James McC. Wearn, Secretary Patricia McLean, and Trustee Brett Madison. Also attending was Carla Kneipp Assistant Human Resources Director.

II APPROVAL OF AGENDA

With no changes to report, Mr. Wearn stated that the agenda would stand approved by the Board.

III PRESENTATION OF HEDGE FUNDS
(This section is verbatim.)

Mr. Wearn: The main item of discussion for this meeting is the presentation on hedge funds, Jeanne Valcik, Callan Associates.

Ms. Valcik: Ms. Valcik, if she is doing her job correctly today will not talk as much as she usually does, so good luck on that one. What we have done here today is, I basically gave this same presentation at the last meeting, and I know that there were some questions that folks had, specifically with the fund to funds. As a result, we decided to have a workshop or an educational session. That is why we are here today. We have Jim McKee here, who is our hedge fund guru. He is located in San Francisco, just happens to be here with his wife and children in Orlando right now, so he hopped on the plane and flew down for it, even though it is his wife's birthday.

Mr. Wearn: So, you're going back I hope.

All: [laugh]

Ms. Valcik: Jim has presented at many hedge fund conferences. He is recognized in the industry as one of the premier hedge fund experts in the United States, he is often times quoted in hedge fund magazines and so on.

Mr. Wearn: Well welcome, we're glad to have you here.

Ms Valcik: Did you want to talk about Lighthouse?

Mr. McKee: Yes. Especially when you anoint me with such an awful title as a premier hedge fund authority. I will certainly recognize that among the national investment management consulting outfits, that Callan has dedicated resources to this that I can certainly appreciate, but we recognize that with 6,000 hedge funds as well, to get into this matter is a lot for a firm to monitor and we have with us today two representatives and I'll leave the details of the introduction to these folks. But locally we have Lighthouse Partners that is a fund to fund that I have been aware of for a number of years in this place, doing business quite a long time and it wasn't simply by proximity that I think you guys will like them. They are here to give you another perspective that is competitive with the fund to fund community. So, I think you're location is doubly fortunate here to have somebody such as Lighthouse, but anyway, Sean, I'll leave the infractions as to let you folks present here.

Mr. McGolden: I'm Sean McGolden, the President and Chief Investment Officer of Lighthouse Partners. We manage about $3.2 billion in a hedge fund to fund format. I've been doing this about ten years now.

Ms. Valcik: So, you started when you were 12.

All: [laugh]

Mr. McGolden: I started a long time ago. Really, what we're known for is just producing consistent returns with low volatility, with very low correlation to other traditional asset classes. So, that is really what we're trying to do is just provide another return stream to a portfolio that is uncorrelated. We've been investing in hedge funds for a very long time, it is what we like to do, we are local here, we are based up in Palm Beach Gardens and have been here for quite some time. Another interesting thing is that we're also closed to new investments, I think we can provide a unique perspective to you, we're happy to answer anything. I know Mr. Garvy.

Ms. Valcik: When you say closed to new investments, you might want to explain this further.

Mr. McGolden: Our partnerships are open-end partnerships and we can choose to take in more capital or not take in more capital, so we've taken in the amount of capital that we want into these funds.

Ms. Valcik: So, you're not marketing.

Mr. McGolden: Yeah, that's what I'm trying to point out here. We're just here for educational purposes and Mr. Garvy asked that we come in and speak and we're happy to be here and we're very open and honest and we're right up the road. Jack, would like to introduce yourself?

Mr. Swan: My name is Jack Swan, and I focus on the investor relations part of our business and distribution of our product which is extremely limited at this time because we are close to new investment. My official title is Product Manager, but I tend to be the spokesperson for Lighthouse Partners in the eyes of a number of clientele which includes institutional investors similar to yourselves as well as university endowments and other pension plan assets as well as individuals and families of particular levels of wealth because of the requirements upon entry into these types of partnerships.

Mr. McKee: I fortunately had a chance to speak with Bob as well as Jeanne to kind of get a sense of what you folks were looking for and I'll be honest, I'm not particularly familiar with your working so to some degree I will look for your feedback to say "yes we're familiar with this or we can move from here." But certainly Bob and Jeanne wanted us to explain in raw terms all the opportunities that we see in the hedge fund community looking at the issues that we feel are important to consider as well the solutions to a degree that we see out there in the market. What I thought I would do initially is present, cover this handout and highlight again some of the why's and why not's of hedge funds. I will be pretty much untouched, the due diligence that is the bulk work of Lighthouse's responsibilities upon the fund to fund manager, and I will let them talk about the issues in a much more open agenda. Mine is a little bit more laid out for you but this can be a great resource here to tap into and ask the questions that you might have. What time frame do we have? I know you have equipment that needs to be somewhere at a certain time.

Mr. Wearn: We're not limited other than by your plane.

Mr. McKee: Well, great. One of the things that I've done in presentations and to begin with really a sum of assumptions for the time to feel comfortable with hedge fund investing, and that is one, that they reasonably understand as a fiduciary what's going on in the portfolio or a hedge fund. Just like you would reasonably understand what's going on in a portfolio of stocks, what kind of stocks do we have, what kind of bonds do we have and such elsewhere in the portfolio and then with that understanding as a fiduciary we can become comfortable with our decisions in hedge fund investing and perhaps most importantly when we go through the market cycles, we enter a dark hour for an asset class, and every class has them, where there is a hiccup in returns that we don't simply pull out at that very moment. Same with equities, people pull out at the most pessimistic moment. So, the whole of this is to get you folks comfortable with what hedge funds are and again make the decision of whether or not you feel comfortable with the risk. Obviously these folks aren't going to care which way you go based on their closure and as consultants we just want you to make a decision that you are comfortable with. With all that preamble, let's go ahead and take a look at what's in the market here in hedge funds. [Page 2]

One thing about hedge funds that is a key to remember is that this is not an asset class or at least we do not characterize it as such. It is more of an investment based substantial on a manger skill while in the use of bonds and stocks, the return that you get is the manager skill and as well with the manager using tools that generally are not available to the rest of your traditional managers, stock managers and bond managers, such as short selling or selling securities that you borrow or buy back at a lower price. Use of leverage. Leverage is generally something that you want to use when your return opportunities are compelling, not something when you are looking to an obviously dire time when you're leveraging your portfolio. The derivatives obviously are a strength that help manager risk, so managers can take the types of risk their working for while hedging out those risks that they don't want in the portfolio.

Ms. Valcik: Jim, is it fair to say that you can't do hedge funds unless you are going to use derivatives?

Mr. McKee: There are so many hedge funds that don't, but it is very safe to say that you are going to be seeing short-selling and derivatives whether of its options, and leverage is something that's used in certain types of strategies, but not technically in others. As we look at the types of fund strategies this is to get to the question where the sources of return from manager skill. There are three very broad brushes of strategies here with relative value, event driven, opportunistic and tactical. We'll take a look at these three types, just so that you can get a look at the land of hedge funds. [Page 3] The first one, relative value, this is where you are a manager of purchasing securities that you like and selling similar securities that you think are over valued relative to what you like and through this equal allocation of long and short positions, you are effectively taking out the market exposure as the market recognizes you're intuition as to the value in the spread. An example is market-neutral equity, I'm not sure to what degree we've gotten exposure here with long-short equity folks, but certainly a typical example might be buying $100 worth of GM and shorting 100 shares of Ford if you feel that GM is undervalued relative to Ford. Even though you have $100 of long and short, the car industry, in terms of it going up or down in the market isn't going to matter so much to you because what your interpretation of what the companies are and that is where the value added is, through the research. Other options, we'll take a brief look at that type of a trade in a moment, convertible options, convertible arbitrage, simply using convertibles for long trades, while selling the underlying stock, the concept here typically or traditionally has been of convertible security, that's like a fixed income security while shorting a related stock. It doesn't pay so there is a natural in the price. There is also a lot of price fluctuation between those that you know are related sometimes, it presents an opportunity and convertibles are particularly of value. So, convertible arbitrage is a popular trade.

Ms. Valcik: Jim or Sean, I have read this number, but what percentage of convertible did they say are now controlled by hedge funds?

Mr. McKee: Well, good question.

Mr. McGolden: The whole universe, its small, of the new issued convertible bonds , when the company sells a convertible bond issue to the public, its probably close to 80%. It's dominated by hedge funds.

Mr. McKee: Another type of relative value trade is fixed income arbitrage. Whether you are buying, selling, a type of assurance that has a higher yield through your credit risk or just a more attractive undervalued situation where we're offsetting market risk interest rates fluctuations with a similar type of security risk or value relatively speaking. This is a trade that can come in many forms. [Page 4] To help convey the value trade on slide four, I'm not going to go through it, but you can, so for people's reference this is a mechanic that buying again $100 worth of stock and shorting or borrowing and selling another $100 worth of stock that you do not defer as much as the one buying. And through time, you're looking obviously for gains on that trade but while you're holding those positions, you've done dividends to pay and dividends to receive. What I am going to focus on at the bottom is the cash collateral from that short sale. For example, when you borrow from the broker $100 of stock and then sell it, the broker is going to want that $100 and then put it into a margin account where it accrues interest at short-term rates. The reason why I am focusing on this is that with short-term interest rates now at 1%, this is not going to be a big return generator as it was three years ago when short-term interest rates were 5%. So, when somebody talks about a relative value trade, I'm going to be generalizing dramatically, but when you look at the perspective outlook for lower than, you frequently hear T-Bill Plus "x" percent, you don't hear S&P returns with less risk. Objectively, that's what their hoping for is better risk adjusted returns with equity like performance, but reality is that there is definitely a short-term length here, short-term interest rate length and so when you look at the hedge fund community, typically it is a T-Bill. Pessimists are going to three percent, optimists are at seven, with markets fluctuating and opportunities changing. I think the trend will be for moving down or moving up. Right now, I think the industry is indicating five percent is a comfortable level.

Ms. Valcik: And that's important to plan sponsors as yourself, because what the initial interest seems to be coming particularly from plan sponsors was okay, your expected return from Callan for bonds going for is 4.75%. Your expected returns for stocks is about nine. I need to make eight and I can't get there. I can't get there with a blend unless I go to nearly 100% equities so that the question initially would come out, well Jeanne, I want hear about hedge funds, because they are thinking of hedge funds as being juice, they are thinking of hedge funds as going to be something in there that we're going to get 12% return off of. So, when I would come and make presentations, what would happen is once I said the expected on this is T-Bills plus three to five percent, lost a lot of interest with an awful lot of people, particularly plan sponsors versus endowments and foundations. The endowments and foundations are interested in it because it's a steady source of income that helps them meet their spending, but plan sponsors have been, frankly they say bring me something that is going to bring me more expected return versus less. The only ones that have gone forward with it are the ones that understand that in truth it is a volatility reducer to the portfolio. So, it's not going to have the volatility of stock and bond portfolio and it will, that's why we have the word hedge, it will hedge the risk level to the portfolio.

Mr. McKee: [Page 5] This is a relative value type strategy, another set of strategies are the event-driven strategies where we look at mergers and acquisitions and look at profitable opportunities there, and distressed opportunities where companies on bad times are either in bankruptcy and what happens then, you have structural sellers, insurance companies or other types of institutional investors who cannot go over investment grade.

Ms. Valcik: That's like us. Just like here in Palm Beach, when we had WORLDCOM that got us. We can't own below investment grade bonds. We were forced to sell into a distressed market.

Mr. McKee: And the hedge fund communities are basically providers of liquidity in this and their purchasing obviously within the lines of a tract of return. We're not talking about a certain T-Bill plus five but when things are going good which I think is 15 to 20%, this has been I think the last year since the WORLDCOM prices have been a very lucrative time for these folks.

Ms. Valcik: But a lot of people say that the distressed debt play is not very good right now.

Mr. McKee: Well, we could certainly get a good comment there, that might certainly recoup gains faster than expected than last June or July. Mergers and acquisitions is an opportunity set that depends obviously on activity levels and these days mergers in activity is low, so in a sense merger activity and distressed are a little counter-cyclical so you are able to come in and out of those two as opportunities present. So, a venture in security or a venture in strategies are definitely an opportunity for hedge funds as prior liquidity to get attractive returns looking at structural sellers who are people that really just don't care about the scrooge, they want to get out. [Page 6] When we look at the third category, which is the more risky one, perhaps the one we typically hear about when someone has a negative comment of hedge funds. It is opportunistic for tactic where you're looking at bottom-up stock picking managers who aren't looking to have an eye for being market neutral, but rather expressing the bets to big stocks but also have a position of long or short market exposure so they will typically have a little bit more of a beta in the portfolio than the relative value or venture in players. In another spectrum of these folks as opportunistic is the top market timers that are the sensitive macro players that are looking at what would be characterized as over valued or under valued situations. I'm not quite sure what the macro communities viewing of China is, currency versus the American dollar but I suspect that eventually the global-macro players are going to be leaning against the dollar as they see China perhaps re-valuing up with securities. So, those are an instance where taking a top-down view and potentially making lucrative returns particularly when markets are readjusting to new paradigms. Managed futures are another group that look at commodity price movements as well as other types of financial derivatives to express positions. [Page 7] When we look at page seven, we talk about those strategies and outline those strategies, we pretty much give you a sense of the high that help us all these strategies and you can see the green that represents that event-driven type strategy where the blue tends to represent the well of the value and you can see that the reddish ones are the more tactical opportunistic ones, certainly where a significant portion of the monies are. This is a floor picture like we see, when you think of hedge funds, you need to think of them like providers of liquidity, like investment banks, operations that trade securities provide liquidity into the market as trend distress, trading mergers, trading convertibles. They are at the fore-front of the investment community and looking for opportunity. I spent four years on the options board for specific stock exchange and I really appreciated what these guys can do because they are at the front-line ahead of the investment managers with their fingers on the pole. So, these folks definitely have an opportunity and this opportunity sets changes over time. [Page 8] On page eight, we're looking at the same color schematic to illustrate how global-macro used to be a much more play in the past as economies became more synchronized. Opportunity set perhaps dwindled but I will not count global-macro out unless there could very well be changes in the market for these folks. And you can see that the greens and the blues have grown over time as the market has become much more efficient in there. With this increase capital, we've got less opportunity for outside returns that these guys have had, but it is still a market that needs a good return. [Page 9] It is probably the statement for why people look at hedge funds but its perhaps again a little bit one dimensional because its performance based. I hate for folks to go into hedge funds because they like the performance but this chart here is illustrating performance of return versus risk and we see these ellipsis representing basically a rolling three year time frame of risk and return and each one of those three year plot points is represented as part of an ellipse. This ellipse is meant to capture 80% of the observed values of these rolling periods. The exact periods are defined in the foot note, but the point of this is that you get a sense of a three year time frame; you can see risk and return for S&P, for the bond market, for the T-Bill, in the gray ellipsis, when we look at the green representing the event-driven or the merger arb, broken out as a distressed. We see more global risk with still relatively attractive returns compared to bonds, buying trades just above bonds, in terms of the ellipse and then the reds and the yellows representing the more market directional or opportunistic, we see those folks out there with less risk in the S&P, but what I find interesting in these ellipsis is if you take away the ones, the global macro and the fixed income line, they are not ellipsis in these directions for total randomness. It has been my impression that when fixed income arb doesn't work, it works when there is a dislocating event like third quarter of 1998, when LONG TERM CAPITAL had its blow-up of all of the relative value trades with fixed income kind of leading the pack. Now, global macro has the ellipse going away, which suggests that they actually get rewarded, and think about it, these guys are looking for dislocating events in the market, such as a readjustment of the pound. When there are big multiple events and paradigms shifting, global macro is generally on the right side of these trades and are participating upside. When things are in places and not moving around, returns tend to be sitting more on cash so there it is a little more episodic but episodic on the upside where fixed income is quite the other way. Diversification is the key and that is what brings us to the next page. [Page 10] There is nothing different on this chart except for this little hollow ellipse that I have thrown on there representing the fund to fund community generally the larger fund to fund community that we follow here at Callan that invest in diversification across may if not all of these types of strategies, and what you end up with after throwing these strategies together is a much more diversified portfolio that has historically been above the Lehman Aggregate. There are certainly going to be times when its dramatically less, like a couple percent less, or dramatically higher, a couple percent above. This is not meant to say that the return series is only within this. This is capturing 80%, so you can imagine 10% is not capturing on the down side, but 10% on the upside. So, we got a pretty good representation that this stuff historically behaves with bond like volatility, I'm not going to say bond like risk, because bond like risk is implies interest rates since its particularly long. Hedge funds have different sensitivities. So, this is a characterization that I think demonstrates the power of manager diversification as well as how this is expected to perform against other asset classes. Now, at this point, I'd like to ask for questions. I'd hate to lose you. [Page 11] With no questions, looking to the next pattern under performance, a little bit of risk, a little bit of return, here is the chart showing correlations. I mentioned to you third quarter of 1998, let's look at that quarter and let's check that particular period, we see these lines that represent rolling three year correlations. We see that in particularly stressful times, correlations grow closer to one indicating that there is a lot of correlation. When there are less stressful times, correlations tend to resume their pattern of uncorrelated performance and so we see things like market neutral equity, the white line, the fixed income arbitrage, the lightning line, all having very low correlations. Now, by the way, the short-sellers are at the bottom of the chart, you expect them during every correlation and that is simply a reflection of the fact that their short in the market. So, almost by definition, they are going to be going down if the market is streaming upwards, particularly if its just a momentum market driving, short-sellers tend to get hit. This chart is meant to certainly illustrate that correlations fluctuate at times and it is at those times that stress will tend to see performance suffer particularly as trade is tied to the market like long-short equity. Now, the final reason why people are looking at hedge funds, we'll tap into this a little bit. The prospective outlook for stocks, the outlook for bonds, Jeanne has already laid this out, and we have already effectively laid out the expectations for hedge funds basically a T-Bill plus five percent. When you think about what stocks as equity capital typically generate, dividends plus five to seven percent earnings growth is the long-term cycle. So, hedge funds may sound like its not determined much prospectively, I would argue that relative to stocks that the risk capital on equity earning hedge funds is looking to achieve similar returns to equities.

Ms. Valcik: Because the dividend rate is very close to the interest rate at this point.

Mr. McKee: Certainly, that's a fact. Certainly when you think about that in that terms. So, intrinsically, there is nothing that is going to give necessarily hedge stocks an advantage. You if you look at historical attribution analysis or just prospectively, you got again a one through four dividend yield and five percent to seven percent growth. So, basically that was expected just like they can be for hedge funds so its difficult to say. But this is different, this goes by a different tune. [Page 13] Now, why not hedge funds? I'm going to just simply address the last point of these six points. I've got a cut little acronym here, FOIL, but I keep trying to come up with one titled FLEECE, but that has an extra E. But, what I am trying to do here is highlight those types issues that institutional investors tend to focus on when they are looking at hedge funds.

Ms. Valcik: There was one that Bob Garvy had asked me that I couldn't answer and that is the fraud without custodian, and he said "... well who custodies them and what protections do we have, because they are actually custodied at a broker." So, maybe Sean ...

Mr. McGolden: As far as fraud, there is generally a couple of ways the industry deals with that. These assets are not part of the custodian so they're not generally at a Bank of New York or someplace like that. They would be held at the prime broker, so they would be with Morgan Stanley. So, very reputable counter part but not necessarily a traditional custodian. The same thing is that most hedge fund investments are done through pull vehicle so if you would be investing in a partnership or in an entity such as yours, probably in an offshore corporation. And these entities are not necessarily transparent and don't have look-throughs to the underlying securities that are held back. So, its an industry proactive to do it that way but it is not a custodian type of relationship that you have with a hedge fund. You're generally investing in pull vehicles and that's why you have to be very careful about who you invest with and who you choose to invest as capital with, which is someone that is experienced and has a lot of knowledge. Can fraud happen? I think fraud can happen in anything. We saw it happen in ENRON, we saw it happen in WORLDCOM, so the hedge fund industry is no different. You tend to read more about the frauds and the problems in the hedge fund world than you do the positive things that happen, just like in any of them, you hear about those things more. But, I think also the role of the administrators which is different than in traditional investing, you typically have a third party that will administer these funds and their role is really to calculate net asset values, distribute statements to share holders. Now, I can't sit hear today and say there is no permit fraud protection. They can also be duped and have been duped in the past, I think they're getting better at what they do. These are professional organizations like an SCI, out of Philadelphia, which is one of the biggest administrators in the world that have teams of people that do this. So, there are layers of protection, but you do have to realize that in most worlds of hedge fund investing, you are investing in a pull vehicle, so the assets are not going to be custodied in your name. They will be held in the name of the fund and you do not have a direct look-through to the specific securities. You have to be comfortable with that aspect. There are various reasons why it is done that way and I think it is a safe way to do it, but like with any type of investing, you have to be careful with who you are investing with.

Ms. Valcik: Are there are any custodians that are trying to get into the business such as a State Street?

Mr. McGolden: There are, but generally why prime brokers are chosen is because they will provide leverage on hedge funds. Also, when they need to sell securities or short securities they need to be able to borrow them. And also, hedge funds want to pipe into the distribution channels to be quite honest. So, they'd rather hold their money than Morgan Stanley, so they get new idea flow, they get research coverage and they got lots of additional benefits. So, there are custodians that are breaking into the business and it would be more common, like the stress stat where you wouldn't need a lot of leverage, where that would be custodied at a more traditional custodian than a firm broker necessarily. But, it would still be the exception right rather than the rule.

Mr. Wearn: Do you think that this is going to address Bob's questions sufficiently?

Ms. Valcik: I believe it will Mr. Wearn, but if it doesn't than we will give that information to Bob.

Mr. Wearn: Okay, that's one of the major areas of concern that I have as a fiduciary for the Retirement Board of Trustees. Because we're ultimately responsible if something goes wrong and I particularly enjoy my life. I'm not comfortable with what protections are in place, its sounds like a leap of faith which is a religious activity as opposed to a business or professional opinion. What happens if something goes wrong, let's take for example, perhaps elaborate. Have you had an experience or observation of a situation go wrong. Can you perhaps explain what happens?

Mr. McGolden: Let's start with some of the contractions that are in place. We believe that there are some contractions and I agree with you that it is probably the Board's number one concern, how to deal with this at a fiduciary level. The protections that are in place when you invest in a hedge fund are hedge fund to fund. You're going to be signing documents basically there is going to be an offering document. These offering documents are done in private places so they are not publicly registered investment partnerships or corporations. Those documents layout specifically what the terms of the investment are, what the rates of the investments are, what the investment manager is going to do, what the liquidity is, what the tax consequences are, so it is a very thick document and in there are a lot of the legalities. Now, those documents I can tell you in reality are complicated, I'm not, and this might sound bad, but I want to be really open without addressing your issues. They are very broadly written. So, if you look at our documents, for our funds specifically, I would tell you that we have a very broad mandate. We can invest in pretty much anything across the globe that we wanted to. And we have certain guidelines that we will follow, but these agreements are very broadly written. So, you have to be careful when you're looking at that, you need an attorney to review them and make sure that there's nothing in there that you wouldn't want. In reality what happens in hedge funds is two things that can go wrong. It is very rare that you have fraud. So, its very rare that you have a manager just take the money and leave. It is a very small community of people, hedge funds are very well researched now, I' ve been doing this for ten years, I've interviewed over a thousand funds. It's a very small nitch type of business. You know who's in the business, you know where they've come from. Back ten years ago, it was a little bit more like a lot less. There was maybe 200 funds, a very cottage industry. This industry has grown up, so there are ways of doing that. There are sophisticated services now, we use back drafts or private investigators to check on people's backgrounds. It is very important to understand where people come from. It is very important to understand any regulatory violations, any investor lawsuits that they've had and all these things have to be investigated. Most hedge funds today are not SEC registered. We are SEC registered investment advisor. We're registered with the SEC, we're registered with the CFTC, the Client Commodity Future Trading Corporation. Most hedge funds are not. I think that is going to change and there's a legislation or there's a document that was proposed last week that will change that. Now, once again I'm here to tell you the practical nature of that, what is that regulation going to do. We are registered, we are visited by law once every five years. A lot can happen in five years, so I wouldn't necessarily let that give you a grade level of comfort. I think in your case, if you're going to use a fund to funds I would demand that they are SEC registered, there's no reason not to. It's an extra step in there, and it just means that they're being looked at.

Mrs. McLean: I think Mr. Garvy did ask the difference between SEC regulated and SEC registered. Apparently, there is quite a difference.
Mr. McGolden: Well, SEC, I'm under the belief now that pretty much everyone falls under the regulation of the SEC. So, whether you're registered or unregistered, I think you still have to answer to the SEC in this country as it relates to matters of trading securities or investing entities, money. If you're SEC registered, it means that they come in and audit you periodically. But once again, I will tell you periodically, that means once every five years. So, we at a matter of practice, hire an outside firm to come in and perform that service for us whether the SEC comes and does it or now. They will be back in, they were in three years ago, but we do it as a matter of course. We have an SEC mock audit come in. So, these are all these things that you can do to help get comfortable. The regulatory environment is open, it will get tighter over time and there will be more regulation in the hedge fund industry, but the strictest things are really the offering document, whether someone is registered or not, past experience, all these things are very important. When something goes wrong in a hedge fund, typically what happens is redemptions are suspended, so in hedge funds you only have a certain period of time, certain amounts of time where you can redeem your money and you have no disrequirements. Typically, you may bill the redeem quarterly and you may have to provide up to 90 days advance notice to redeem your capital out. When something goes wrong, the first thing that happens is redemptions are stopped. So, you would get a letter that would say "redemptions in x, y, z fund are now suspended" and every offer that I have ever read, the general partner or the investment manager has the right to do that. It is a very powerful right. So, we won't waive it.

Mrs. McLean: At any time?

Mr. McGolden: I am painting the bleakest scenario for you. I really think it is absolutely the right thing for investments. I think people should invest in this. I'm just giving you the realistic scenario, what is going to happen.

Mr. McKee: But to be clear, here we're talking about the hedge fund itself. Now, in your experience, have you ever seen any fund to fund ever have a fluke, particularly in 1998 when it was bad news to be in a hedge fund.

Mrs. McLean: Is that LONG TERM CAPITAL?

Mr. McKee: Yes, that is LONG TERM CAPITAL. I actually don't know the answer. So, I am pretty curious.

Mr. McGolden: It would be very rare. I have seen, I've heard of it since its for brief periods of time where that is done, and I'll get into that issue. It's larger and related to valuations related to LONG TERM CAPITAL and related other hedge funds. We'll talk about the valuation issue which is something else.

Mrs. McLean: Isn't there a Canary Fund recently that was in the paper, but that was a problem with timing of their market trades.
Ms. Valcik: They made money.

Mrs. McLean: Yeah, they got busted!

Mr. McGolden: When things go wrong, I'm mean in the case of canary, actually all the capital was returned, so canary is a very regulatory case which has been even rarer.

Mrs. McLean: Now, are they a hedge fund or a fund to fund?

Mr. McGolden: They were a hedge fund. In fund to fund, you don't see the suspension of redemptions. That would be a very strange circumstance. But in hedge funds, that can happen. It brings up another issue, which is the valuation. The valuations of these, hedge funds and fund to funds. Her job is to worry about all these things. So, if you choose the fund to funds route, which I think is the best route for you all, obviously a bit more bias than that, but unless you're going to have a dedicated staff of people doing this it really doesn't make sense to go directly. If you go fund to funds, they're going to take care of all these issues for you. They're going to do bulletins and they should do it properly and there's lots of good fund to funds out there. They're going to worry about the terms of liquidity of the ongoing managers, they're going to be concerned about how they value things. They going to report to you on a timely basis what's working and what's not. So, they're going to handle all of these issues but underlying that, kind of what we do, that's why we're employed, we get people to where they want to go and to the destinations they want to go. But, occasionally we fly through some bad weather and we deal with it. We have systems that deal with it, we have methodologies that deal with it, but lots of things that go on behind the scenes that can happen. Fraud is very rare in this industry, I think its probably less than the domain of public securities. And if the fund to funds is doing their job, you're not going to be involved in a fraud. As a fiduciary, could you be invested in a hedge fund to fund that invested in a LONG TERM CAPITAL, where you're sitting there answering to the employee's in your plan and saying "yes we had an investment with a fund to funds that invested in LONG TERM CAPITAL," how big of a position is that going to be? It might be five percent of the fund's assets and you may lose money, but sometimes it is during the darkest times in the hedge funds that it also produces the best opportunities. I think that generally there is a lot of work done to assure people that there isn't just ramped fraud in this industry or ramped regulatory problems in this industry. There is a small percentage.

Mr. Wearn: I think one of the things you said that is important is that fraud is very rare in this industry. I'd like to know why you think that is. Is it because it hasn't been discovered yet, or is it for some other reason?

Mr. McKee: First of all, this is a market that really isn't characterized as complacent. There are so many watch dogs in this area because it isn't regulated and they know that if they don't verify the integrity of the prime broker, the integrity of the fund administrator and the managers they're dealing with through some third degree of reference, that is a friend of a friend of a friend finally getting to somebody who's not going to have a bias of that manager to give the indication that this guy has integrity. This is a market that is definitely non-complacent. Usual fund market, up until a month ago was complacent, and I was very shocked with the rest of them but they let people basically get free money. Hedge funds get free money. They're violating SEC rules, but the fact is because there are regulations we were complacent and so I believe that is going to clean up the problem with mutual funds and a much better situation, but I think in this market you don't have complacencies. So, everybody looks for a line of interest and on top of the reference checks with all the service providers and one of the major points is that as long as the manager has his or her net worth, a substantial portion of it on the line next to yours as is almost always the case with these guys, you know that they are going to be executing for better or for worse, trade in the best interest of not only your money but his money or her money. So, it is in the interest that helps one as an investor get comfortable but if they're going to be doing the right thing and certainly when I look to a fund to fund community when they're investing I want to see a line of interest on their part. In other words, their money is also next to mine in a fund to fund so that we don't have an agency that is, when you go to a typical institutional bond or stock portfolio, they're not investing monies side by side, because frankly they can't necessarily do that. There are a lot of reasons but certainly you find that more rare to see on interest there. Those are my views on why fraud is minimalized, its not a complacent market, there's alignment of interest and the checks and balances are certainly pretty comprehensive.

Mr. McGolden: I think, to answer your question of why it is a small percentage, I think it is generally a small percentage in any type of business or industry, so don't think the hedge fund industry is immune from that. I think Jim brings up some good points as far as alignment of interest. But, if we look in the public markets, and I'm not bashing them, I think they are very efficient, but if you look at the frauds or ledge frauds in ENRON or WORLDCOM, its almost twice the size of the hedge fund industry.

Ms. Valcik: In a fund to funds, if you had a fund to fund that was invested in the LONG TERM CAPITAL, what sort of level of hit would it be to our investment?

Mr. McGolden: You saw in 1998, our fund was no different. We were invested in LONG TERM CAPITAL, and LONG TERM CAPITAL wasn't a fraud, it's the use of too much leverage and had a problem. You generally see a loss of a peak in the assets of a fund to funds. If you had a million dollars invested in a fund to funds, most fund to funds would have lost in that time period probably about ten percent, so you would have gone from having a million dollar investment to about $900,000. In our case, we lost 7.5% over relatively short time period, and then made a lot money over the next twelve months for very structural reasons, and that's why I generally bring up the point that sometimes when things are going wrong just like in any market, it can prevent an interesting opportunity to invest. I'm glad they don't happen that often in the hedge fund space. I've been doing this for three really distinct periods where that has happened and hedge funds are not these magical investment vehicles, that it is a safe ride up and there's never any problems and I think sometimes there sold just to say "they're going to make money very consistently and they'll never have to worry about anything. I just think of it as a part of a portfolio and they have unique risk and return attributes that really help diversify a portfolio. I think the industry has very strong self regulation and it's a very tight nit industry where someone does something wrong, you're kind of blacklisted and the managers are. I mean, you're done with, you're out of the industry. So, Jim's other point, generally these funds were started to manage the manager's money, and they wanted it managed in a very specific manner and particularly going back ten years this was their capital at risk, so it may have been $10 million of personal worth, but was in there just being managed the way that they thought it should be managed and that still holds true today. I think that is very important and whoever you decide to enter this asset class with, you need to make sure that the principals have their money invested along side of yours and that is just a must. They have to do it.

Mr. Madison: Now, is that something that is disclosed when you go in and you do all this thick paperwork that you are describing. Is that normal, you can go in say "I want to know that you have your assets in there with mine so I have a degree of faith in what you are doing."

Mr. McGolden: It's not listed in the documents, but its something you certainly request.

Mr. McKee: In the audited financials, there should be some degree of competence, because they are saying that the general partners' money is "x" percent of a fund, and that's another one of the checks and balances. Everyone looks at an audited financial, not only of the underlying funds but certainly you look at the fund to fund community.

Mr. McGolden: So, you do want to verify.

Mr. Madison: And you can ask for it? Its not an unusual request?

Mr. McGolden: I don't think it is an unusual request. There may be some people who say "no."

Mr. Madison: Then we look for somebody else.

Mr. McGolden: I think there is going to be a lot more saying "absolutely, we will prove to you that the principal's investment is 'x' amount."

Mr. Wearn: What percentage of the fund are we looking for in the principal's investment?

Mr. Swan: It depends on the type of the fund but it could be significant. It could be extremely significant, but I think the question to ask is "to what extent is your net worth committed to the fund that we are looking at to invest in?" is the question that is pretty riveting. What is the investment team's commitment personally into the fund that we are looking at for consideration?

Mr. Wearn: What percentage is built in that? What are the parameters?
Mr. McGolden: In a big fund to fund, it could be if someone is running a $5 billion fund to fund, it may be less than a percent. But, it still may be a lot of money. Its more than half of their net worth committed to strategies which they are directing. You want people to have absolutely more than half their net worth invested in what they are doing.

Mr. Madison: So, when they come in and we say "okay, what's your net worth and what are your percentages in this fund?" And if they go low then that raises a red flag, is that accurate?

Mr. Swan: Well, I would ask to what degree are you committed and have conviction of any strategies. You can ask them what percentage of their own capital is committed to the strategy.

Mr. McGolden: And make sure you're down the path a little bit. It wouldn't be the first question that you throw out there but its not a taboo subject. Its just not, you want ...

Mr. McKee: I don't know any fund to fund manager that doesn't ask how much money is in the underlying hedge fund. Maybe not to the extent, I don't know.

Mr. McGolden: It's a fair question.

Mr. Wearn: It might be a silly question, but isn't there a way to verify independent?

Mr. McGolden: What you want to see is probably the statement from an administrator, except from a third party administrator. I think if you get to that level of deception, and I'd imagine if you're to choose this path, you're going to be dealing with a very reputably fund to funds that has been around for a long period of time. So, there's lots of ways to verify things. You need to check references, and ask around and those questions are no off limits, its just something that is done, if you want to be in this business you just have to be subject to that type of scrutiny.

Mr. Madison: Is that something that Callan does if we decide we do a search and is that something that Callan would do to come back and go through all of that?

Ms. Valcik: Fortunately, we have a guy here at the table.

Mr. McKee: Certainly, looking to the degree of the audited statements, I frankly haven't gotten letters from fund administrators saying "... is this percentage of investment representative of the fund to fund managers personal wealth?" We're not looking so much to that level. Alignment of interest is certainly key at that level, but it is particularly key at the underlying hedge fund level. This is one reason why Callan frankly doesn't go into the direct fund to fund, direct hedge fund investing. We see some reputable people out there that have a long history of trading and sometimes we don't have network to connect like these folks do or those institutional investors that have staff of five or so, dedicated to hedge funds to check all this stuff out. So, we are relying upon audited statements of hopefully Ernst & Young or somebody that is recognized and to a degree the statements that the fund administrators is providing and supporting those documents.

Ms. Valcik: The statements show that the general partner has the investment.

Mr. McKee: But, we wouldn't be able to tell what they are doing underneath.

Mr. McGolden: You'd have a real tough time verifying what percentage of it is in their net worth. You'd want to see a significant investment in the fund by the principals of the fund. I think it is important.

Mr. Madison: You talked a lot about the regulation in trying to make sure that everything is in alignment. It seems that you are being very proactive. Is there a reason, is there something that happened in the past that or is it just that you are being good guys?

Mr. McGolden: You want the knowledge of who you're dealing with because these are pulled investment vehicles. So, we're not there everyday to see what they are doing and if you see something that may be of questionable character, if you see fights with "x" investors or "x" employees, it can be indicative of a pattern of problems. Ninety percent of the people check out completely clean, there is no issue but I can tell you that our background checks have eliminated probably four to five investments that we might otherwise would have made had we not taken those steps. So, its important to do that and I'm not sure what the regulatory bodies do, like the SEC that check the people's backgrounds when they will apply for a license. I'm not a hundred percent sure if they do background checks on, you know, people who apply for SEC registration, that's why I bring it up, I wouldn't, its comforting but its not, you know.

Ms. Valcik: I've been listed on an ADV before, nobody ever checked me out.

Mr. McGolden: So just understand when we hear about all these regulations, it may not be getting you what want.

Mr. McKee: But its in the public domain, which is key. In the fund to fund community, most all of the ones that we're dealing with or at least getting comfortable with for recommendations are registered investment advisors where as I think in your area as we look in the underlying funds, it would be almost the exception that they're actually a registered investment advisor with the SEC. However, certainly things might change, as we know. With this canary matter and other reasons particularly with money flowing into this space, it makes to me, as an institutional fund representative, compelling sense to be regulated because I can see who the principals are, I can see who the relationships are in a public domain and if you're willing to put on paper that is available on a website at a click of a button that type of fraud is going to be quickly unearthed because this is a business where words spread rapidly. So, that is why we always required it among the fund to funds, now it just seems like its going to be coming to that. But, in any sense.

Mrs. McLean: I have a question about the fee schedule and how this compares with normal trading, the fees, commissions.

Mr. McKee: This is certainly one of those things in the fat document that Sean was referencing that gets disclosed and that's the management fees of typically in underlying funds. I know the SEC is actually looking to promote, elevate that level to a higher degree of transparency. Its always been understood but not described in detail, typical one in twenty relationships with the underlying fund manager, one percent management fee and twenty percent of profits over zero. That's at the fund level.

Ms. Valcik: Relative value manager, for instance, his fee level would be one percent plus twenty percent of the profit.

Mr. McKee: So, you think about, for example, a manager in a firm's eleven percent return, they put a management fee of fee one bringing it down, the gross down to ten and then they'll take typically twenty percent of the after fee profit, so they take another three percent, two percent.

Mrs. McLean: That's pretty steep isn't it? I mean in comparison to our ...

Mr. McKee: In comparison, when you, now, I agree, that's why the brightest minds can do it go in here. But, you live and die by the sword, and also one of the things to remember is that we're not just managing a 100% long here, we've actually been paid, so many strategies here have a hundred percent short. So basically, instead of $100 we have $200 of capital of the trade, or in the case of levered funds, such as a fixed income arm, you may have six times or seven times that capital, every capital base that we're charging one percent on. So, leverage should be compensated but I'm just indicating that the stress points are certainly higher and certainly come in hopefully a better captain of the ship than what might be coming out of grad school, you want to certainly see somebody who is capable of earning that. So, if there is ever a place for this, certainly in hedge funds, it demands that otherwise if it were for longer everybody would go back to a mutual fund complex and stay there.

Mrs. McLean: Now, staying with that, if you go to a fund to funds that adds another layer of commissions or fees.

Mr. McKee: There is another layer of fees and you typically see, I see people under this level but I typically don't see one percent management fee on top and often times you'll see a profit participation five to ten percent. So, same question, well that sounds certainly like a lot and certainly a small, I don't know where the breaking is, but I just doing the math myself, looking at the staff of these fund to funds and the principals involved. Let's say they have $500 million, that's implying a $5 million fee that their clipping right at the get go, forget about incentives, but if I have a staff of 20 or 30 of high powered individuals in command and salaries of six digit figures, you've pretty well ripped through that budget on $500 million.
Mrs. McLean: I need to go into business here. I need to switch.

Mr. McKee: I understand, it's only when you do a $1 billion that I think it becomes frankly luker. Sean, I'm not sure to what degree.

Mr. McGolden: The $500 million is about the break even point.

Mr. McKee: Industry representation to say, a typical budget is $5 million.

Mr. McGolden: But, there is also one another thing too that's an important job of a fund to funds. When we go out to make investments, we're also negotiating fees. So, if we bring size to an investment, we have the right to dictate terms in certain instances.

Mrs. McLean: But those standards are what you just told me. That's pretty standard and they are negotiable.

Mr. McGolden: Some people get much higher fees. I mean there is a fund out there that you think is the best in the world, but will make 4% management fees this year and 44% of the profits.

Ms. Valcik: I know where you're coming from. These are incredibly high fees but I will tell you that any asset class, once you get out of marketable securities. So, once you get into skill based inefficient asset classes, this is the level of fees you pay. This is the same level of fee that you'd pay for a real estate manager. If you were in ventured capital, fund to funds approach, same double level of fees, and I know when I was a plan sponsor, we were first considering venture capital I was screaming because I' m a cheap accountant. I'm screaming and yelling and so on, but eventually got over the hurdle to understand that its simply what you get in return. So, these are skilled based, high paid strategies. We can, looking at we pay Roanoke and Loomis, we're paying 35 basis points, but those are liquid markets. That is they way the fees are. I remember getting together with public funds, big public funds, going "we're going to beat these guys down, we're going to quit paying them these fees," its still the same fee level, and that was ten years ago. So, the fact is that it is the cost to get in and it hasn't come down.

Mr. Swan: We have found zero correlation between lower fees and stronger risk adjusted investment performance. The fee objection or the fee discussion rarely is a challenge in our business because what investors expect is to pay for really a level of manager skill and investment return with very little dependants on the direction of general markets. So, you can get dependants or exposure to what the equity markets will be doing in a very low cost manner. What you can't do in a low cost manner is create an investment that is not dictated by the direction of equities or by the direction of interest rates or even by the direction of credit spreads. So, there is an argument there that says "if we are seeking absolute returns and capital preservation in any market environment, we think we substantiate the fee and we're willing to pay a higher relative set of fees to preserve capital namely in disastrous equity or interest rate market environments provided we know that this is only one component of our overall portfolio." Its those arguments which have brought really the fee structure in the hedge fund community to where it is today. And there is appetite to protect portfolios with these different investment styles and with that demand comes a level fees that investors are willing to pay.

Mrs. McLean: I can understand that from an industry point of view, but as a fiduciary, our job is to enlarge the investment bubble or the return bubble and on the other side of the equation is, we have an obligation to keep the expenses down and this is an awful lot of money to authorize our membership to pay for investments that are not transparent, we can't tell them where the money is. There are a lot of problems that I see with it and then to boot on top of it, we have to dip into their funds and pay these fees, I just have some real problems with that. I mean it maybe appropriate in endowments, it may be appropriate for a very wealthy person, but I'm just not sure that this is the place for it.

Mr. McKee: I understand from a point of view of fiduciaries. I know from my personal point of view, I crossed that bridge long ago, with personal investment in fund to funds. At least one that would accept me. I wanted to be an investor and so I won and I did it. I had the documents and I was like "yeah, this is great," I wanted to expand my portfolio, the market had already been on a tear of 20% or whatever. I'm thinking attorneys can't keep on going like this, so I wanted to diversify just we're suggesting here and we couldn't cut the check, my wife and I. It's a lot of cash to round up, and we missed the window. Suddenly, a quarter later I had a 10% discount on my investment. So, that was great. Anyways, fund to fund investment, I get over that fee, I'm with Vanguard in my 401K portfolio and have Vanguard for my next portion. If I had my representation, I would pay for just Beta in one part of my portfolio and then a significant if not all of my portion going into the alpha of hedge funds. I admit I have certain beta exposure, but I want a good chuck with the alpha. Anyway, that is just my personal view. I like to pay for things separately. Beta exposure which Vanguard does and then alpha. So, their fees may seem high relatively speaking, but when you look at it per dollar alpha, its actually demonstratily cheaper . I admit you have to go through some exercise to strike out any kind of implied beta and stuff like that, so its not just simply an easy measurement but the fees are by the way netted out in all these examples that I've shown you. So, as you look at these fund to fund fees, their net of the fund to fund fee, their net of the underlying fund fees, and objective here is the T-Bill plus five. Now, those guys that are charging four percent and forty five, they are the ones that if you look at a return strategy, you as an investor would say "gosh, its worth paying that 30% one year, 25% the next year ...," while the market's tangling. These are reputable firms.

Mr. McGolden: If you saw the infrastructures in these firms, they are really out-source investment banks, trading desks that come off investment banks and banks. I mean to recreate these entities would cost hundreds of millions of dollars. So, people won't try anymore and these are the individuals in the entities that picked up on that early. But, it sounds like a lot of money but they actually, in terms of employee systems infrastructures, they burn through it and continue to generate very high rates of profit. I look at this as businesses, the only cost in this business is labor and generally its cheap when you look at other business, so if the main component of a company, 60% of basically the cost of any business is labor, you know you can an argument that the cost of labor in this business is basically 20% of the return. So, the fees are high, I would never sit and say there not, I think they are justified but the ultimate justification is only going to come with the returns. If the returns aren't there, you exit.

Mrs. McLean: The absolute worst case scenario, a client could lose their entire investment and still owe money?

Mr. McGolden: No, you're limited to yourinvestment, well I don't think you can. I think you're limited to your investment, whatever you put in it.

Mr. McKee: There are exceptions. When you're talking about fund to fund investing, there is no way you can lose more, frankly in the worst case scenario its been like ten percent. That's pretty worst case scenario, but everybody ran to the sidelines on this capital, but I don't think.

Mr. McGolden: From a legal perspective here you're invested in a pulled vehicle as a limited partner. I think the maximum you can lose is your capital.

Mr. McKee: Interestingly, there is a twist, to this would you go into separate accounts. Now, you can have some separate accounts going, so maybe you can answer this one (referring to Mr. McGolden), but I know one fund to fund that prided themselves on direct investments, separate from management accounts and had an investment in 1994 and while the ones that were limited partners that lost 100%, they actually lost 110%. So, you have double the transparencies, a double edge sword. You want to look at all the security levels, you got to make sure you have it pretty well designed so that when things go wrong, you are at least pulling apart quickly. These guys did not pull the plug quickly enough and ran through all the equity capital on a highly leveled situation, whereas a limited partner that things go rye, it's the prime broker basically and the other community that grab all the equity capital they can, if they can under a hedge fund manager, but at the end of the day if they let someone be over levered, they lose money. That's why a lot of people like Solomon Brothers pull the plug on a lot of managers in 1998 because they didn't know where one was going to come. The prime broker is your first line of defense. They want to make sure, their not worried about your equity capital, but they're worried about what's behind it. So, there's a lot of people that have the best of interest that hedge funds are working out, not just for the managers dealing.

Mrs. McLean: That would be my next question, saturation. But I think you've touched on that.

Mr. McKee: All the first five levels letters are to these guys because its their job to evaluate managers at the underlying level, but the only one I pull aside to is the diminishing returns issue.

Mrs. McLean: So, that's a real issue. Everybody's getting on the boat and the boat has to sink sometime.

Mr. McKee: Everybody's going to have a boat but I will tell you from Callan's perspective, I was just telling Sean earlier before this meeting that our client base is going on the third or fourth round of just education and I'm going back to these folks. For me its job security. At the end of they day I want you folks to be ... I know we're never going to be comfortable with hedge funds, we're never going to be comfortable with equity risk or bottle risk, frankly, the way efficient markets work, but I think that from our client base very few actually put monies into the space. What you should be worried about are the big states going into this. CALPUR, one of the biggest cities, if not the biggest, has already said "we put a billion into this, and we thought we'd get $11 billion on this," maybe make a significant portion of the fund, but their slowing down their investments at one billion. That makes it less than one-third of a percent of their corpus. So, they can't really make an impact. They got five guys devoted to this, a bunch of guys.

Ms. Valcik: Virginia is a big state.

Mr. McKee: Virginia is getting into it, just starting to. [Page 17] So, there is total of about five or six states that have outlined them. There is a lot of them have haven't done it. They've been looking at it for a long time and the only ones with size was Pennsylvania, Ontario teachers and CALPUR. Across all of them, I'd bet there are probably about five or six billion, but this is when you think of the monies that these guys control, they recognize capacity as an issue and their more anti than the smaller investor, the smaller fiduciaries. So, you'll see this public plan list dramatically increase when you go down the municipal but the important thing is in terms of don't lose your money that the states haven't gone in it, is any indication of the equity market. I remember when new households helped Indiana state teachers invest in equities for the first time in 1997. They got invested in September 1998, they missed the down draft, so that was great, but anyway, the point is that they took I think about 150 years before they got comfortable with equity after the Erie canal long, every canal equity issue.

Ms. Valcik: Citizens of the state voted on a constitutional amendment every other year whether to invest in equities. So, they had turned it down every other year for 150 years.

Mr. McKee: So, we remember LONG TERM CAPITAL, they remember the Erie canal. Its never going to be a good time perhaps to invest in basically equity risk. Hedge funds are capital at risk, kind of like this investment bank as Sean was describing. Its not a complacent area, I think it is unfortunately the high network individual who doesn't have the resources that these guys have but just relying on a friend.

Mr. Wearn: Let me interrupt a moment, and go back to the timing issue. Does anyone need or want to take a break?

Mr. Wearn: Okay, and your time frame (referring to Mr. McKee), you have a plane at ...

Ms. Valcik: At 12:20 p.m.

Mr. McKee: Sometime in the next 20 minutes I'd say would be good for me to leave.

Mr. Wearn: Okay, well I think maybe we should let you go on and finish up.

Mr. McKee: At this point you guys have been asking the right questions. These are certainly the right questions to ask. Prospectively, what to expect. This is a symbiotic relationship, you have to understand about that.

Ms. Valcik: I think we have covered a lot. Maybe sixteen, why you would invest in hedge funds, because we certainly we put a lot on why not.

Mr. McKee: We represent this as a risk diversifier. It is a different source of return than simply the beta of the markets, so as long as you appreciate the infrastructure of hedge funds, basically its kind of a symbiotic relationship on capital markets, where if there is training opportunities, if there is issuance of convertibles, issuance if IPO's, any kind of corporate activities, all these types of things present opportunities for the hedge fund community to be participating ahead of everybody else just by virtue of this infrastructure. This is a relationship that will provide returns as long as the capital markets have activity. If I were to see where the downside is on hedge funds, its not the fees, its not the fraud, its when the markets go into a flat line, where they don't move anywhere, the transaction levels drop, because nobody's investing in businesses, nobody's devolving business. That is when things in the hedge fund community I believe will hit a hurdle and what happens in that is that they go to cash, they typically go to cash or these guys are on top of them to make sure they don't level up to try and make a bigger number and then you get basically a T-Bill life insurance. That's what is the worst case scenario for hedge funds, is that competition and everything puts this thing to a moment where the alpha is compressed or confined through such. Are we there yet? I was just kind of suggesting that because the states are not there yet and because frankly you guys are asking all the questions that everybody else is asking. There is a lot of reluctancy going in as a fiduciary, so when I look at the total size of the pool, of five or six hundred billion or seven hundred billion in hedge funds verses capital markets of $20 trillion, where I start to worry is when I see that number go to from $650 billion to $1.2 trillion or $3 trillion or something like that. So, suddenly you're seeing that the tale of the dog could be wagging the dog. Hedge funds live off of the opportunities of the capital managements regardless of which way they go, as long as they are alive and well. So, diversification returns is the key for the hedge funds and capacity constraints isn't really so much an issue for you, but it certainly is something to keep an eye out as you have to with any asset class, is there too much money in this space. Yale University is pretty top notch in dollar, I thought they were going to turn down their absolute return just because there is a perception that a lot of people are getting into this, but as the canary in the gold mine of institutional investors, I don't know about the analogy of the canary, but they are the brightest minds in the institutional community and they upped their allocation from 25 to 27. So, contrary to what I thought he'd do, David Swanson there headed upwards. Capacity is certainly something to be aware of, and as long as the market continues to be healthy and vibrant, I'm not too worried about it.

Ms. Valcik: Sean, are you concerned about capacity? I've read articles that say hedge funds are going to grow and become very because they add so much to market efficiency, its sort of the opposite side.

Mr. McGolden: I think absolute return investing will continue to grow. I think it is a good way to manage money. I think it is especially for plan sponsors, endowments, foundations, things like that. I think it probably helps better match their liability. The way we structure things and the way we have structured our funds requires basically a certain, basically the mathematical problem we have. Hedge fund industry is only so large. The way we like to make our investments is, we like to put a decent amount to work in each investment. Hedge funds themselves aren't that large and they are not going to let us be a disproportionate share of their capital. So, if we like twenty hedge funds in the universe, and let's say for example we could invest between 50 and 100 million dollars in those hedge funds, what I don't want to do is just double our manager list and grow our funds, because I think that would dilute the returns to our investors, but at the same time I can't just go back to those existing managers and say take more money. So, that's what we face. We're probably unique in that respect. There are other people with different arguments than we do. We'll expand the manager list or do different things, we just chose one path. Whether we chose the right path or other people have, it will take years to determine that, but we're very comfortable managing what we're managing and I think there are other groups that are more comfortable in their process to manage more money. So, I couldn't look at what we've done as an indication. That capacity is drying up, its just the way we prefer to manage our partner's capital is really what it is a reflection of. I think this industry can double without any problem.

Mr. McKee: As long as there is trading opportunity is there. You're underlying managers will say "I have room."

Mr. McGolden: I think there is lots of room and I think that absolute returns strategies will continue to become more prevalent.

Mr. McKee: Again, with managed growth we're all comfortable with that. At this point we haven't seen any throw caution in the wind and that's always perhaps a good sign.

Ms. Valcik: I remember that in the papers that Jim wrote that hedge fund investments should be between five to ten percent of the portfolio, less than five isn't worth it. And greater than ten starts to change the diversification benefits of your other asset classes.

Mr. McKee: Plus you have a liability issue I think, you define benefit with obviously some kind of a discount rate, times a long bond, these aren't at all necessarily driven by long bond rates. These types of opportunities are an appropriate bond portfolio. So, liability much is an issue particular for pension funds. Endowments are a little bit free from that, their just looking for a real rates of return.

Mr. Wearn: We appreciate you being here very much. I don't whether there are any other questions that we have. Thank you and thank your wife too.

Mr. McKee: Hopefully we answered Bob's goal as well.

Mr. Wearn: I hope so too. I think that your elaborations were a very big help. So, thank you. Do you all have some additions to make.

Mr. McGolden: I don't think so, I hope I didn't paint too bleak a picture of this industry, it's a great industry and a great investment vehicle and I think it should be a part of plans' portfolio. I really feel strongly about that but its different, its just different than investing in traditional stocks and bonds and there are some things you have to get used to and there are some fantastic benefits and then are some other things that might appear to be drawbacks, but I really think this is a safe way to invest capital and this is all I've been doing in the investment universe for ten years and its worked out very well and I still think there are structural inefficiencies to take advantage of, the hedge funds do a very good job.

Ms. Valcik: Sean, do you have any clients that are pension plans verses endowments and foundations? Are they corporate plans?

Mr. McGolden: Yes, they are large corporate plans. And they enjoy the experience and it was a new experience for them and I think they are becoming more comfortable with it and I think that they recognize the drawbacks to it and they are fiduciaries and we're fiduciaries the way we manage the money for them as well. So, we take it really seriously, we learned a lesson on pension fiduciary liability, things like that. But, you know, we're comfortable with what we do and I think they're comfortable with the way that we do that and they do like the diversification benefits in there as well.

Ms. Valcik: I've been receiving calls from corporations in Atlanta and wanting us to come over and talk about what they can do different in their portfolio. That's really what they're looking for is to talk about hedge funds. Absolutely.

Mr. McGolden: I mean, Jack, you deal with the clients more than I do.

Mr. Swan: When you're working with the pension groups, they really have to educate a pretty elaborate board and the first order of business is to dispel what is commonly associated with this hedge fund phrase and driving through that and understanding, its really a structural reference more than anything and then getting at the investment process of the team is, so its an education effort as Jim had mentioned as well and ultimately the way you come out is whether you have conviction about it, if you understand the process, you believe in the team and it makes sense for a very small portion of your portfolio. If you're not there, you shouldn't allocate and that's perfectly fine, I mean we've had a lot of "no thank you's" in our experience and we understand that, we're not the solution for everyone, but for those who have an eye toward controlling risk, controlling losses, managing a moderate gradual growth of capital, it can make sense for a portfolio, but its an education effort, it's a belief system and it doesn't happen very quickly and so its good for us to be here, we're not here to market availability in our funds, we run a very tight business, but for us to be able to just talk openly about or industry is really good for us. Its also good to hear your feedback and skepticism and I think it's a healthy skepticism to have and that is the scrutiny that keeps the majority of our business extremely clean and extremely executable.

Mr. Wearn: The one analogy that I would draw on it is based upon personal experience, I'm a lawyer and I sat down and shared grievance committee for the Florida Bar and I know that we have a certain standard of ethics that we have to comply with not only those that are set forward and the model rules by the American Bar Association, but those of the Florida Bar which are regulated by the Supreme Court. And then, we have levels of peer review and assessment of performance and there is a place for complaints to go for those to be preliminarily investigated to determine probable cause and then to go to hearing level and then all the way on up the various sanctions. And the concern that I have with the trust and faith of the individuals who are in the industry such as yourselves and I certainly am not pointing fingers, but I fail to see a lot of those protections which I have experienced and know that they work well but they certainly don't work perfectly, because I expect everyone at this table would say there are a lot of lawyers out there who aren't up to standard as they should be, and that's the biggest concern that I have getting over and it sounds to a large extent like it's a leap of faith in order to get beyond those.

Mr. Swan: I've also wondered why that level of scrutiny is not pursued on the investment teams of large mutual funds. There is an assumption that there is a degree of security. When you really don't know much about the conviction of managers, their own commitment of capital into the ideas that they're managing, granted they're under the veil of the SEC being registered as an investment company.

Ms. Valcik: Its actually difficult for a manager to invest in a security that he wants to buy for the fund. Its like darn near impossible. I worked for an investment management company that had mutual funds for four years, I just didn't trade and I was in marketing and it just wasn't worth it. All of the hoops you had to go through, you had to have it approved and the company couldn't have been trading in the last thirty days and so on. It is true, having known some mutual fund managers since I worked for a mutual fund company, some of them are gun slingers.

Mr. Swan: So, it's a question that we can't answer. We enjoy the scrutiny because it takes our industry to higher level.

Mr. Wearn: Do we have any further questions?

IV ANY OTHER MATTERS

Mr. Wearn: Is there any other business to come before the Board? We do again very much appreciate you taking the time especially when you're not looking for business to come and help us in our education because that is very important and you provided a service to your industry and we appreciate it very much. And thank you also for coming here and thank your wife and your children. We do appreciate it.

Mr. McKee: Thank you.

V ADJOURNMENT

Mr. Madison moved to adjourn, Ms. McLean seconded, the motion carried unanimously.

Approved: ________________________
Patricia McLean, Secretary