



CAPITAL
MANAGEMENT

“The Case For Alternatives Continues”

TEXPERS

2009 Summer Educational Forum

August 2009

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A long-term approach to alternative investing

Are you...

...happy with your portfolio's 2008 performance?

...struggling with current asset allocation?

...over-diversified or too concentrated?

...re-thinking your approach: consultants, FoFs, or direct?

...grappling with internal limitations: staff, committees, boards, city and state mandated rules?

A rough ride...

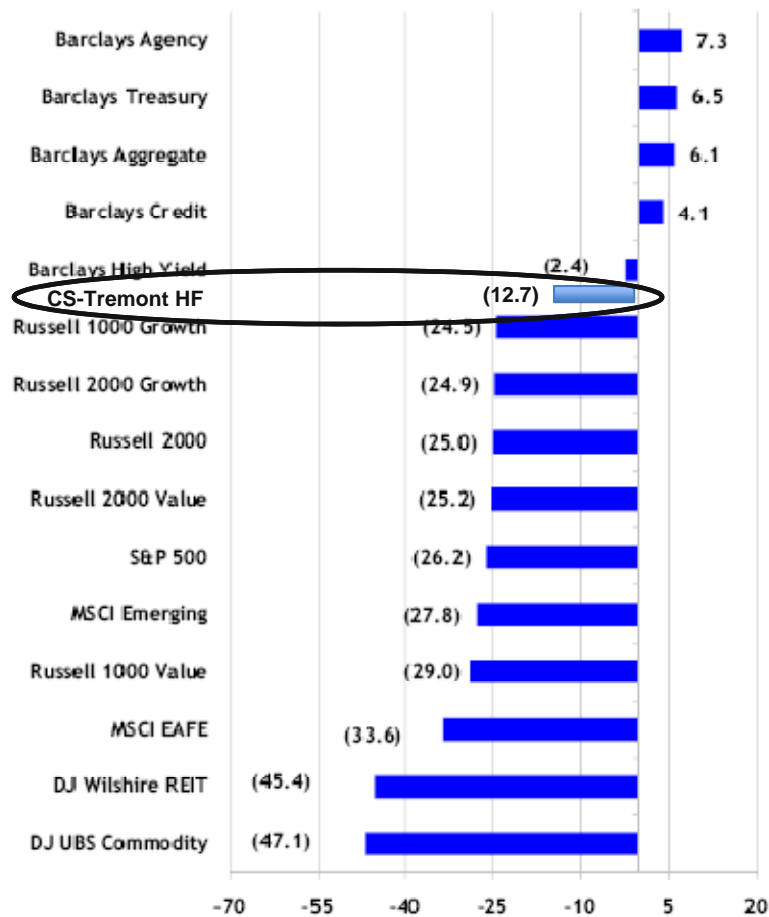
S&P 500



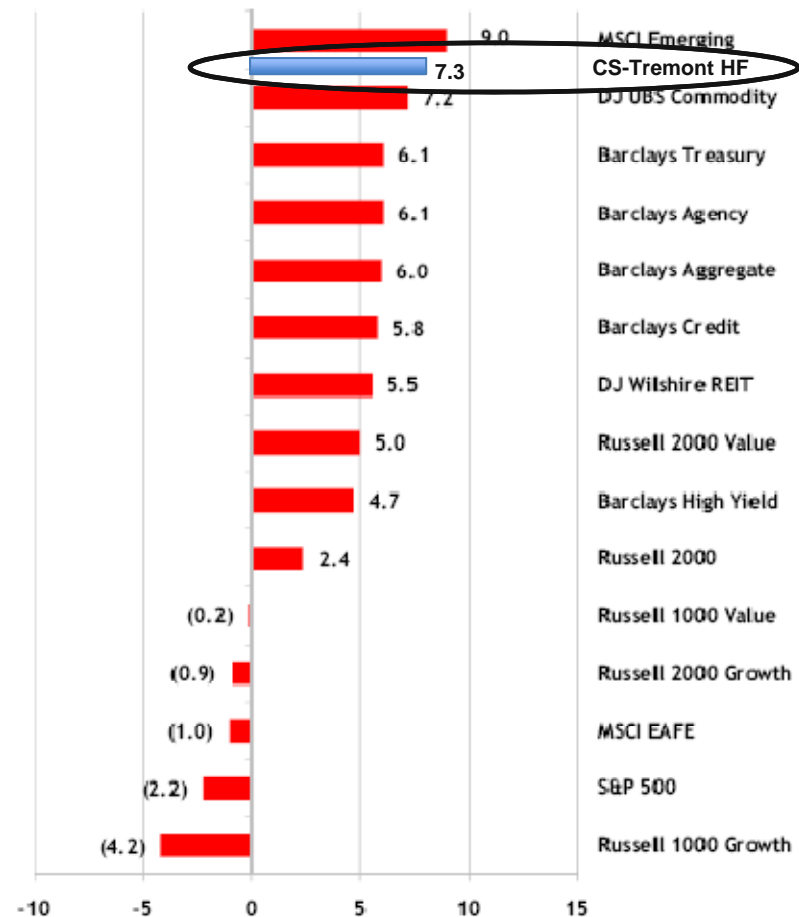
Source: Bloomberg

Capital markets: can they rebound?

Major Asset Class Returns Over the Last Year - June 2009*

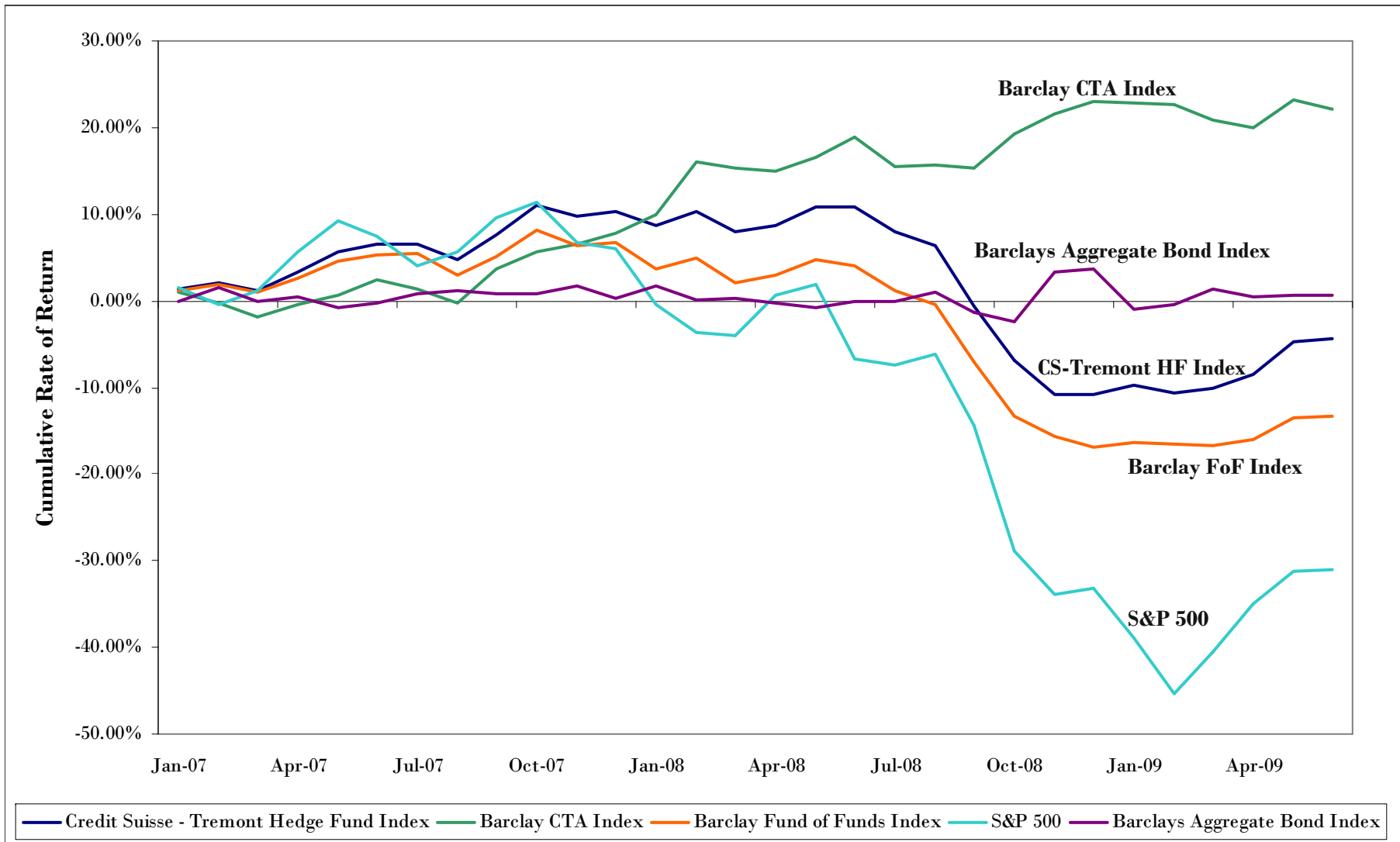


Major Asset Class Returns Over the Last 10 Years - June 2009*



Source: Wurts & Associates, Quarterly Research Report, June 2009
*Annualized returns

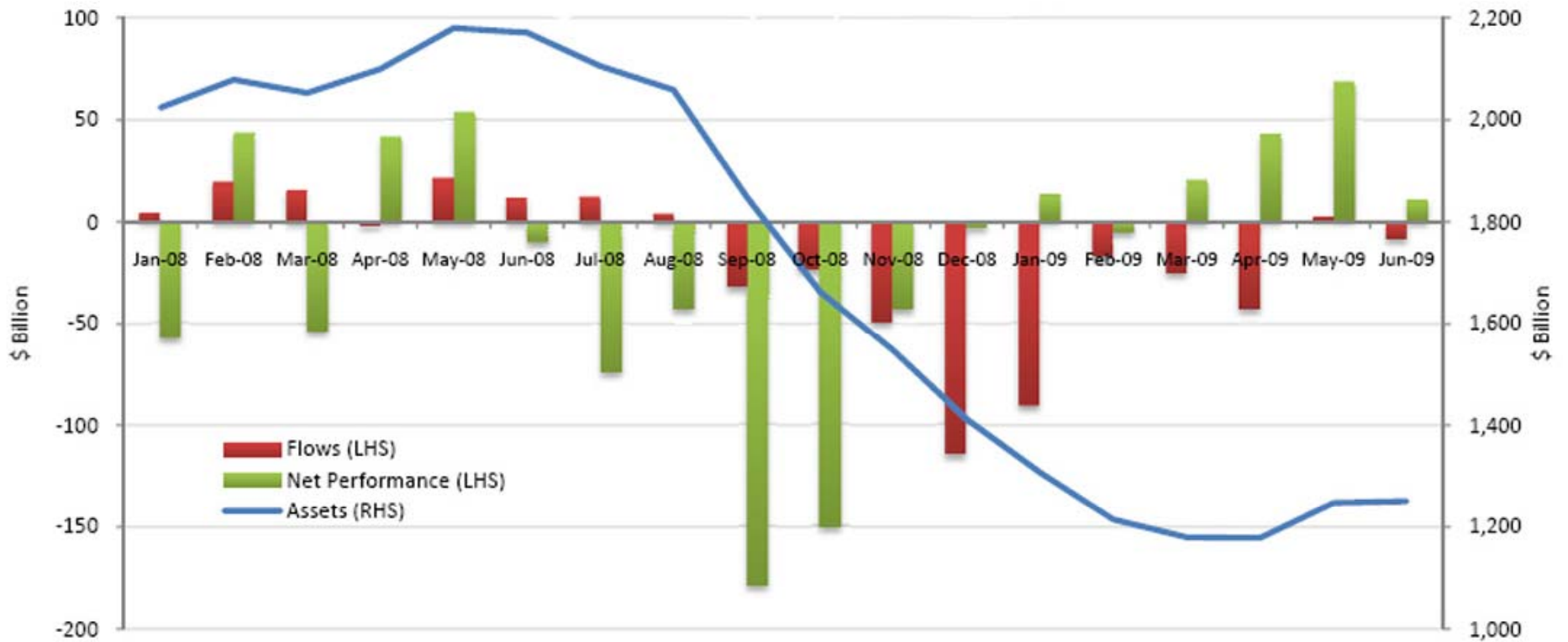
The case for alternatives?



Source: Bloomberg

Reversal of the tide?

Hedge Fund Assets, Flows and Performance



Source: Barclays Hedge Fund Flow Report, August 2009

Looking back...

What went wrong?

No Risk Discipline

- Targeting returns *not* risk
- Inappropriate position sizing – where were the stops??
- With low volatility and tight spreads, risk dial turned up at wrong time
- Delevering too late
- Mismanaging liquidity

Infrastructure and Business Model

- Lack of experience through multiple cycles
- Getting in too early
- Trying to “catch the bottom”
- Focus only on investment returns but not operational risks
- Running business silo in nature
- Over-reliance on models and systems

Lessons learned

Risk Discipline

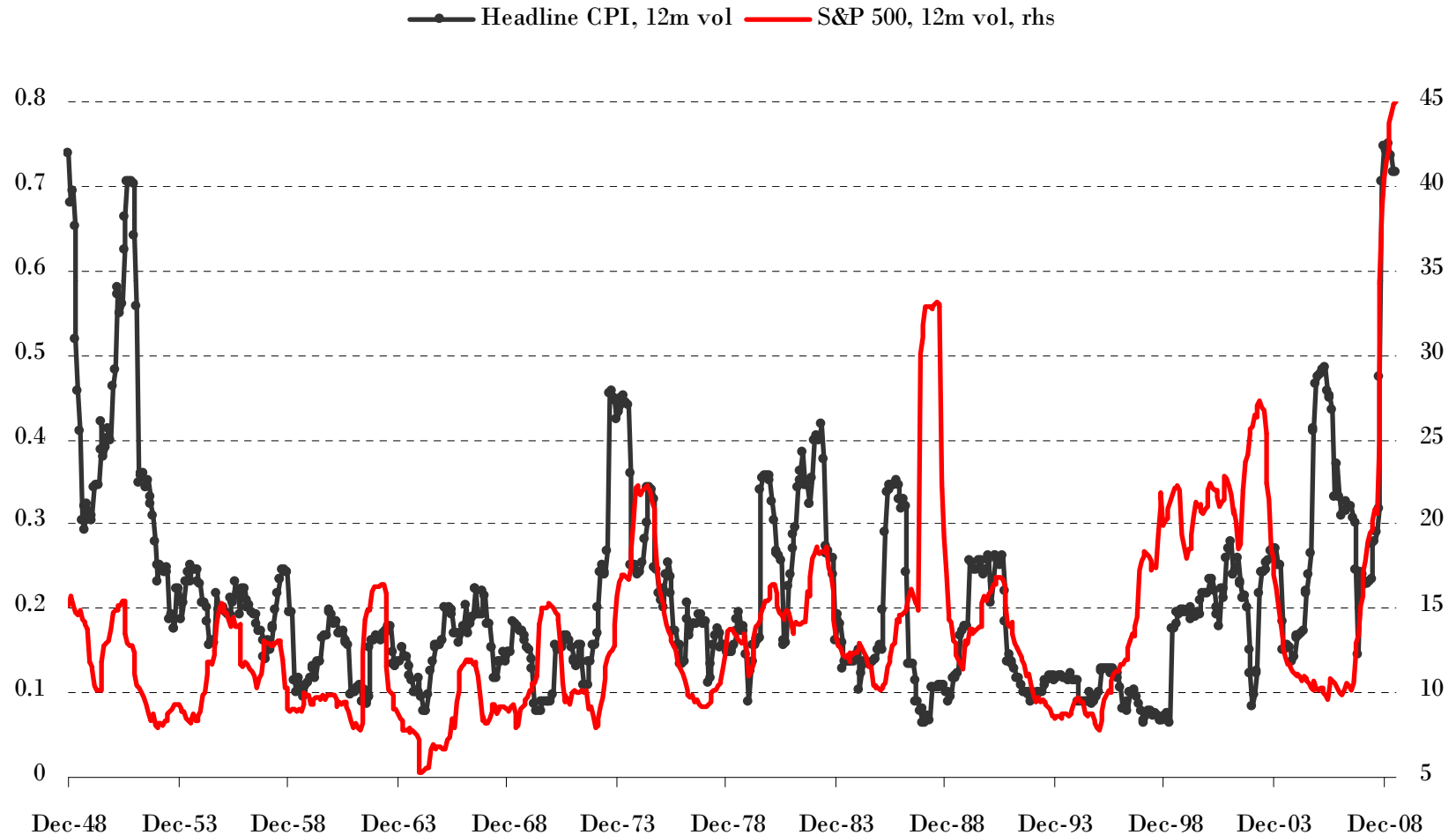
- Target *risk* not returns
- Need independent and centralized risk management with **authority**
- Counterparty risk management is essential
- Real stops and targets
- Forced mark-to-market with live bids

Infrastructure and Business Model

- Markets are correlated and interrelated
- Need a top-down, macro outlook as well as bottom-up, fundamental views
- Infrastructure, conviction and experience as important as investment decisions
- Requires a collaborative culture – teamwork and open communication
- Hold your opinions (“trade ideas”) lightly
- Models should aid the decision-making process, not drive it

Looking forward...

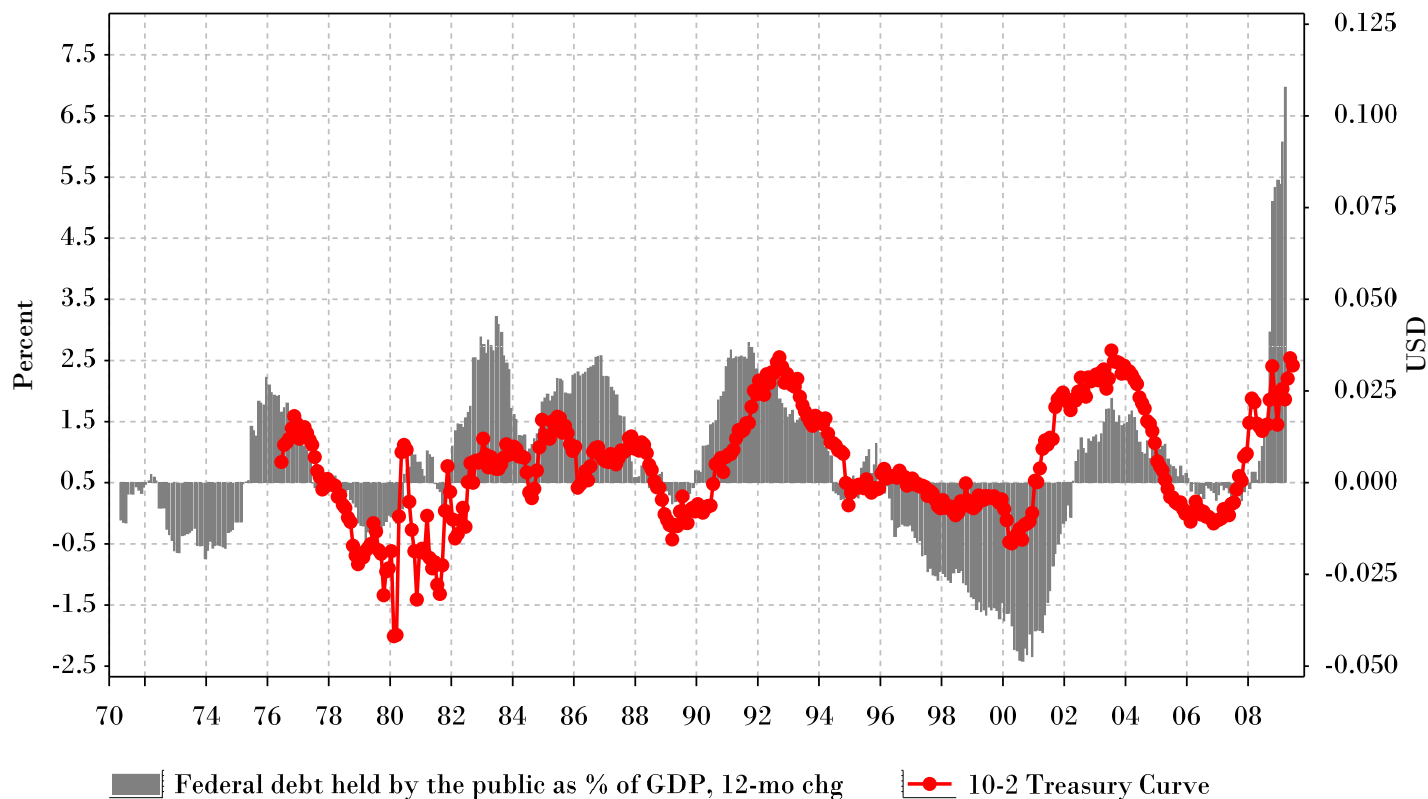
The new normal is less friendly



Source: MKP Capital's proprietary systems

The new normal is less friendly

10-2 Treasury Curve and Changes in Federal Debt Outstanding



Source: Reuters EcoWin

- Policymakers have responded extensively, and the imbalances created by this response have not been allowed to manifest themselves in prices.
- Generic duration risk is another source of longer-term volatility in fixed income markets.

The checklist

Questions you should be asking potential managers

History and Experience:

- How long has the manager been around?
- Proven track record through many financial cycles?
- Have they ever put up gates or limited redemptions?

Infrastructure:

- Well-established and developed?
- How much has been reinvested into people and technology?
- How long to get above high water mark? What does that mean for infrastructure?

Modeling and Research

- What is the depth of their research capability?
- Multi-market framework and expertise in understanding cross-market correlations?
- How robust is R&D? Technology? How experienced is the team?

The checklist

Risk management:

- Is there a centralized risk group? What is its authority?
- Is there a Chief Risk Officer? What is his/her background?
- Do all positions get live bids? Are stops used to manage risks?

Counter-party risk management:

- Is there a specialist?
- How to decide which counterparties are acceptable credits?
- Bear Stearns, Lehman exposure?

Financing and cash management:

- Is there a full-time specialist?
- Where do they keep their cash?

Pricing:

- Is there a separate group responsible for the valuation process?
- How do they mark portfolios? Is it a liquid NAV?
- What process do they employ to test the validity of their marks?

Appendix

MKP Capital Management, L.L.C. (“MKP Capital”) is a diversified alternative manager that seeks to deliver top quartile risk-adjusted returns by employing a three-pillar investment approach encompassing global macro, structured credit and systematic trading strategies. Founded in 1995, MKP Capital has been a Registered Investment Adviser since 2000. The firm is defined and differentiated by three factors: a collaborative culture, a focus on risk management and a commitment to integrity and transparency.

Maurice “Chip” Perkins, a Founding Member of MKP Capital, is responsible for Client Development and Investor Relations. Prior to the founding of MKP Capital, Mr. Perkins worked at Salomon Brothers Inc. (1983 to 1996), serving as a Managing Director in the Fixed Income Securities Department, where he headed the central United States region of the Institutional Mortgage Sales Department. Preceding that, Mr. Perkins worked at MCI in New York from 1980 through 1983 where he was a National Account Sales Manager.

Mr. Perkins received a B.A. degree in Economics from Denison University (1980) and completed an internship at the London School of Economics.