

# HEDGE FUNDS

THE VOICE OF THE ALTERNATIVE INVESTMENT INDUSTRY

July 2005

REVIEW

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## LAUNCH

## Mena Capital prepares Arab fund in Bahrain

London's Mena Capital is planning an equity fund investing long/short in the Arab world and Turkey. This is the first hedge fund for a region, that up to now has barely appeared on the radar screens of the hedge fund community.

Khaled Abdel Majeed, founder of Mena Capital, says the fund targets 15%-20% net annual returns over a cycle after its launch, which is slated for September or October.

The fund, prime brokered by Citigroup, is being domiciled, and possibly also listed, in Bahrain, thereby improving the chances of it being granted access to the Saudi and UAE markets, still largely closed to foreign direct investment.

Islamic law forbids shorting, so Abdel Majeed will organise some of the fund's short positions directly with stock lenders. Over time, he expects countries such as Egypt and Morocco to allow shorting. Corporations' foreign-listed shares can be shorted.

Before establishing Mena, Abdel Majeed worked for Blakeney Management running institutional money, as well as at EFG Hermes

and Arab Bank. Also joining Mena Capital is David Ederly and Russell Hendry, each with extensive management experience.

Investors should not see the region as uniform, Abdel Majeed says.

There are oil exporters such as Saudi Arabia, Kuwait and UAE and oil importers such as Jordan, Morocco and Lebanon. "Then you have countries that march to their own tune, such as Egypt and Turkey, which are plays on internal reform."

Even where markets may be driven by similar factors – such as Saudi Arabia and Kuwait, there is a correlation of around 0.2, providing diversified factor exposures within the portfolio. The markets as a whole are also not highly correlated to Brent Crude's price, to gold, the S&P 500 or the MSCI EM Free Index.

Abdel Majeed notes the Gulf region's demographics and high unemployment rates are driving reform and economic liberalisation to attract private investment and create private sector jobs. He adds, global accounting standards are applied to listed firms there.



Khaled Abdel Majeed, Mena Capital

## LAUNCH

## Saxo Bank offers global macro programme to institutional investors

Denmark's Saxo Bank intends to launch its global macro programme to institutional investors as a Cayman Islands-domiciled hedge fund targeting returns of 15%-20% gross, with standard deviation of between 7% and 10% annually.

The fund, whose underlying programme has been available thus far as managed accounts, which will remain available for subscriptions of at least \$1m, will have a margin to equity ratio of between 7%-10%.

Steen Jakobsen, executive director, fund management, at Saxo Bank, said the programme trades "all liquid futures markets," which he defines as those trading 12 hours a day.

Up to 10% of the fund's assets can be allocated to less liquid futures markets, Jakobsen added.

The programme mixes a systematic approach to trading with a discretionary, Jakobsen and his team can size and express trades, as well.

While allocation of fund capital has historically been around 40% to foreign exchange, 25% to fixed income and the rest to various long/short positions in other markets, Jakobsen noted that this could change at different periods during the business cycle as the managers saw opportunities arise.

While the investment process imposes no hard-and-fast limits to sector allocation it imposes a risk control of 2% of the fund's assets to any one position.

The capital in the programme has returned investors around 5.5% gross in the first quarter of 2005 to April, on top of 20.94% in 2004, and 31.39% in 2003.

The Danish bank already has a foreign exchange programme, launched in 2000.

The global macro programme (euro class) returned its investors 67.78% between its January 2003 launch and 31 March 2005.

Please note: News comes fast in the hedge fund industry. All comments in this report were made in April 2005, before the downgrading of GM and Ford by ratings agency Standard & Poor's, and should be read with this in mind.

## PENSION FUNDS

## Philly fund calls on consultants to 'look out for little guys'

Brian Glanz from the investment unit of the Philadelphia Board of Pension and Retirement has called on consultants helping pension funds with hedge funds not to ignore smaller and emerging hedge fund managers.

Speaking at *Hedge Funds World: Global Opportunities 2005* conference in New York recently Brian Glanz said PBPR's consultants CRA Rogers Casey had done an "excellent job" helping the fund decide which hedge funds to invest in.

However, he added, some consultants went predictably for the bigger hedge fund firms when producing shortlists.

"A consultant will not get fired for

recommending a huge hedge fund, but I do not want our board to miss out if the better managers are the smaller ones," Glanz said.

"We need to get consultants to open up and look at the smaller groups. But I do not know how much time they have to do that because there are 6,000 funds out there."

The Philadelphia fund expected to make its first fund of hedge fund investment by the end of the summer and Glanz had earmarked one of the pension fund's three moves into funds of funds for a smaller, emerging manager with less than \$1bn under management.

"With the help of our consultants we are looking at an allocation

of 6% to hedge funds and we will go into FoHF's initially. As we become more familiar with the asset class we will go the direct route over time," Glanz added.

PBPR's pension pot has around 60% of its \$4bn in equities, 25% in fixed income and the rest in alternatives, mostly (10%) in private equity.

Ultimately its allocation to hedge funds will come to about \$250m of which a little less than \$200m will be via funds of hedge funds, Glanz said.

While Glanz said he could stomach an allocation of up to 10% or 15% of the pension's assets in hedge funds, he added that politically this could be hard to get past the board.

# Should we tell the President?

BY DAVID WALKER

If you want to find a body inimical to hedge funds, look no further than the office of New York attorney general Eliot Spitzer.

And if you want to find a body with the same, or greater, level of influence and power than him, willing to see more sizeable hedge fund melt-downs, says Philippa Malmgren, former economic adviser to President George W. Bush on the national economic council, look no further than The Federal Reserve.

While Alan Greenspan has spoken of hedge funds adding liquidity to markets and aiding smooth trading, Malmgren, who now works at the Canonbury Group in London has said the Federal Reserve is willing to accept a repeat of the LTCM blow-up of 1998, as the bank raises rates during 2005, and may even welcome the chance for a rising rate environment to flush out the industry's over-leveraged, less well managed funds.

Malmgren's abiding theme when talking of hedge funds is of times of crisis and crunch separating the smart money from weak processes and risk controls.

The government and Fed is ready for a blow-up of a poorly managed fund, Malmgren has said in the past, "the question for investors then becomes, are you in a well-managed, unleveraged, fund with an experienced manager, or a highly leveraged, poorly managed fund that might suffer?"

A strategy of the Fed to raise rates could also flush pension funds out of a reliance on equities, and help them absorb the excess Treasuries after Asia's banks have satiated.

## THE SEC'S EAGLE EYES

Nor has the SEC's interest in hedge funds waned since it voted to force registration on most of the world's hedge funds, from 2006.

William Donaldson, the SEC's commissioner, has said in the past few weeks the pressure on managers to beat markets could "lead to disaster," necessitating greater regulation of the sector.

"If history is any guide," he said in a public speech, "it is just this sort of pressure that can lead otherwise well-intentioned professionals to pursue practices that can ultimately result in disaster for the investors that they serve."

"While I do not believe that our registration initiative will prevent

all scandals from occurring in the future, I am hopeful that it will provide a much-needed ounce of prevention by helping to foster a culture of compliance," he said.

"Given the size of the market and its growth rates, I believe we would have been remiss had we failed to take action."

## DANGER: CURVES AHEAD

Speaking recently at *Hedge Funds World's Global Opportunities 2005* conference in March, Malmgren has furthered her warnings to hedge fund managers in the present climate, giving a stark warning to beware of three main traps in 2005.

And none of the three, Malmgren said, would be visible to managers via their standard market and data information screens.

The first, she said, was the chance of a repricing in China or an event that "tells us the China story may not be worth what we thought it was."

"The Chinese stock markets are down dramatically in the last few years and the view in the market is that we have already priced it out.

"But," she added, "Chinese markets are not that certain. For fund managers the real issue is that all the traditional businesses – that is, Fortune 500s and managers in China – have no exit strategies (from China should something go wrong)."

"It is not that the economy will slow down and will cause a repricing, rather it is there will be an event that causes repricing causing capital flows to slow."

"Do we think we have an Enron in China?" she asked, "a company we thought was completely sound and it turns out to be fraud?"

"China Aviation Oil is a company that lost \$500m punting on the foreign exchange markets in a way unrelated to their core business and had nothing to do with hedging," she said by way of example.

"That loss should raise the question of do we think this is the only company in China that is doing this?"

"Most investors in China cannot afford to ask the question because they cannot afford to get out if something goes wrong," Malmgren said.

As an example, Malmgren noted that presently one of China's fastest-growing industries was advisory services for foreign firms on how to exit China if things turned sour.

"This is an issue public policy officials are thinking about if the markets do change and they're wondering what China is worth and what does this mean for emerging

markets?" Malmgren questioned.

Another pressing issue for China, of course was Taiwan's sovereignty, or lack thereof. Malmgren explained the Beijing authorities felt "if they ever have to ask the public to tighten their belts to deal with the issue, they would do it willingly.

"But if you ask the public in the US to do it to deal with the issue, the answer would probably be 'Where is Taiwan?'"

She added she felt Beijing had an economic strategy vis a vis Taiwan – or Chinese Taipei, depending on whose perspective one takes – to give Taiwanese firms an easier exit (if need be) from the mainland.

"This is, so when they ask 'Would you like to make money or like to return the right to vote, I have a feeling over which way the people will vote.'"

## CREDIT CRUNCH

The second danger on the horizon, Malmgren said, was a Fed moving from being below neutral on rates to move target rates up, and what this means for credit and high-yield strategies.

"Liquidity is now generally being withdrawn and we are still below neutral, but once we get to neutral the breathing period will be over and it does constrain what points to pricing in that environment."

Malmgren said if people were offered cheap money for extended periods, "it is likely someone has made an investment that's undisciplined and wrong.

"We have use of capital in the corporate world that will turn out not to be profitable and, once the tide turns, we will see which business lines and hedge fund strategies have made bad judgments about how to deploy capital."

Malmgren said, from a policy maker's perspective the world can be separated into the winners and losers, and foresee the capital that was available to the weakest players on a market shake-out will become available to the stronger players.

She said the stock pickers' markets have been a case largely of choices between firms that have strong management and those with weak managers.

## PUBLIC POLICY DANGER

The final potential danger to hedge fund managers, and possibly the one most apparent to the public at large, is US public policy, both foreign and domestic.

While the press's story has been the president "turning into a nice guy in Term II, reaching out to the Europeans," Malmgren added she held a very different view.

"I think the Republicans have come to power a second time with greater conviction their original view was correct and now is their last chance to get it right."

"If you look at the conservatives now, they have appointed John Bolton (America's under-secretary, arms control) to the UN and Karen Hughes to the State Department. We have to pay a lot of attention to the vision the administration has to foreign policy," she added.

A key issue for the US, the Middle East and indeed the world, would be the issue of Iran, where the US and non-UK Europe is, for once, in agreement.

"We are seeing an intensification of the pressure from the US and Europe on Iran and that will produce some very important movements, which we need to be thinking about as an event risk."

Malmgren said energy issues were "at the centre of the pressure," and produced a "huge amount of geopolitical risk," again, not immediately visible,

"We have an environment with many of the players in the OPEC world who traditionally did not want the price of oil to go too high because they did not want to give a windfall to Russia or help the alternative energy providers.

Philippa Malmgren said terrorism bred where there was an exploding population and in "poor and broken states...and in the Middle East," she said, "you have up to 50% of the population under 16 years old."

## COMBINED EFFECT

All these event risks, Malmgren said, represented a "huge opportunity to make money" for skilful asset managers, but at the same time produced a "nightmare to those who could not manage these types of events."

"The real risk is that in some point of the cycle you get tested and that's when you sort the weak from the strong.

"This is the period we are now entering," Malmgren said, "and as we get closer to neutral (on rates in the US), and knowing what central banks are thinking in that liquidity will not be what it has been, we will all have to contend with that environment."

# Expect oil at \$150 by 2015: Rogers

Jim Rogers, co-founder of the Quantum Fund with George Soros and commodities commentator, has issued a stark warning to attendees at the *Hedge Funds World Global Opportunities 2005* conference – oil will run to \$150 within the next 10 years.

Rogers was negative on chances of the oil price being forced down in the near future.

“The question on oil will be how high the price goes and stays, because there may be vast amounts of oil in the world but no one has discovered a great oilfield in over 35 years.

“The Alaskan and Mexican fields are in decline, and while the North Sea has seen the UK one of the great oil exporters in the last 20 years, within the decade the UK will be a net importer.

“In the 1960s we discovered North America, Mexico and the North Sea, and the world knew the oil would come to market, but the price of oil went up 10 times, because it could not get to market quickly enough.

“If you think the price of oil is going to \$32 and staying there let me know where the oil is coming from. I expect the price will be \$100-\$150 within the decade and the bull run in commodities will come to an end when it reaches \$110.”

Adding to this woe is Rogers’ outlook for Saudi Arabia, one of the world’s largest oil producers: “The country is basically run by three people, over 80, and about 70% of the Saudi people are under 21. There is huge tension and unrest under the surface and there are huge numbers of foreigners like Indians and Bangladeshis and Pakistanis doing all the work and running the businesses, so either there will be chaos in Saudi Arabia – and that’s likely – which means the price of oil will stay high – or the royal family will pay everyone off.”

(Rogers likened Saudi Arabia to Mexico in one respect, in that there was a large young population and its resources were approaching their end, pointing to social unrest.)

“If you have a serious decline in the source of revenue for your country and a lot of young people you are bound to have a lot of instability going forward. People have said all commodity bull runs end with a war and if that’s true by the end of the next decade there will be a lot more turmoil in the world. When you have a country on the rise it always clashes with the dom-

inant power in the world. At the moment that power is the US and the country on the rise is China.”

In short, he said, the alternative of alternative sources of energy “cannot happen fast enough.”

## ASIAN PROMISE?

On the topic of emerging markets Rogers was disparaging of the Indian growth story compared to China’s prospects.

“India is one of the most extraordinary countries in the world, but as an investment destination it basically is a sham, although there are some great success stories.”

Pushed together “in a panic” by the British in the 1940s, India, Rogers said, was run in an “anti-capitalist way” by the Nehru and Gandhi dynasties.

“When you look at the infrastructure you would think the road from Mumbai to Calcutta would be one of the greatest roads in the country,” he said, but it was less than impressive.

Only half of Indians stayed in school until they were 12, he claimed, “and the well educated in the country are the minority.”

Rogers contrasted India to China in this respect, where different ethnic groups do also cohabit in the latter, they are 94% Hmong Chinese and everyone can read and write the same language.

One attendee at the conference put forward the question of India’s greater prospects due to its having democratic institutions, whereas China does not.

“Indians are always using the story of them having democracy and tolerance. They do have tolerance, but I would say there is more tolerance in China than the US press would have us believe.”

Turning back to India, he noted: “In 1991 India was bankrupt and had three weeks’ of foreign currency reserves because Socialism had failed and in the next 10 years they had privatised only one company.” This last point, and Rogers’ contention this firm was a bakery, was hotly debated at the conference.

“If you can find the right Indian company to invest in you will make money,” he said, “but you won’t be finding it with my money.”

## BEWARE THE RUSSIAN BEAR

Rogers was even less optimistic about Russia, which he labeled a “disaster spiralling down into a catastrophe.”

As with India, Rogers said part of its problem stemmed from the dis-

parate ethnic groups and their ability to live harmoniously. This could be countered in India by the fact their national leaders have been from all different religious groups, and even the so-called Untouchables.

“In the Soviet Union there were 124 languages and ethnic group and most of them did not want to be there,” Rogers said.

This situation, he added, had changed little now.

“It is capitalism, but it is outlaw capitalism and if you’re in the elite and know the mafia and can play with them then you can make a lot of money, but otherwise you cannot get the money out of the country.”

Rogers painted a picture of a president with “little control” over the nation and the Red Army “holding it together, including Chechnya where you have 1.5m people in an area the size of Connecticut.”

“It is little surprise Russians are getting their money out quickly.”

## BROKEN CROCKERY?

When it comes to China, Rogers expects a ‘hard landing,’ at least in the nation’s real estate market.

“The best way to invest in China is to buy commodities,” he said, “because the Chinese will never buy light bulbs or chairs from us, but they do have to buy raw materials.”

Rogers clearly sees China as a major fueller of the commodities bull run, and one that was not part of the last energy bull.

But when will growth be hampered by inflation and the commodities bull run be finished?

“Bull runs in commodities have lasted, at the shortest, for 15 years and at the longest for 23 years,” he said, “and this has recurred throughout history for the last 200 to 300 years.”

“We have seen long bull runs in commodities followed by bear markets, and they last on average for 18 years. So if history is any guide this bull run will last to between 2014 and 2022, but I suspect it will last longer this time.”

He noted it did not take economies to be generally healthy for a bull run to eventuate, as in the 1970s “many major economies were in the tank,” notwithstanding the bull market running its course.

“The UK was one of the biggest economies in the world, but, in the 1970s, it was bankrupt and we still had one of the greatest bull markets in commodities because supply was going down faster than demand.”

## LATIN ALLURE

Rogers was most upbeat on Brazil, with “great natural resources and unlike Russia stability.”

“Brazil has a lot of natural resources in a time when resources are going through the roof, and even the Socialists want to be rich, and the leader of the country wants to be prosperity,” Rogers said.

“Of India, Russia and Brazil, if you have to put your money into one of them, put it in Brazil.”

## FLAWED GREENBACK

Rogers continued his attack at the Hedge Funds World conference on the US dollar, branding it a “terribly flawed currency,” and not one his new daughter’s savings are held in (their in Swiss franc).

“The dollar has been the world currency for about 60 years and is having a rally and should rally even more. But until 1987 we were a creditor nation,” he added, “while now we owe the world \$8trn and it’s going up \$1trn every 20 months.

“It is very flawed fundamentally and it is their policy in Washington to decrease the currency, the central bank wants to drive it down.

“It is going to get worse and I do not see anything that will change it.”

Rogers foresees the US stock market “not doing much” in 2005 and deteriorating in 2006, a trend to be followed by most Western markets. Rogers would, however, be long Japan while short the US.

“In 2007, we will probably have a big rally, but, in 2005, bonds are in a bear market. The bull market in bonds lasted from 1981 to 2003 but that bull is over and bonds will go down for the next seven to 15 years.”

## DEMOGRAPHIC TRENDS

Rogers noted the heavy importance of demographic trends on markets, and painted a gloomy picture in particular for Europe and the West in this respect.

The influx of immigrants into Western Europe from the East was not being matched by birth rates to support the present population in old age, he said, “and then in Japan you have got the lowest birth rate in the world, and they have no immigration at all.”

“Either you need a lot of babies or immigration, or a serious decline in the standard of living and the Japanese it must be said have opted for the latter.”

*Please note: Rogers’ comments were made before Crude most recently hit prices levels above \$60per barrel.*

# 2005 – the end of the hedge fund carry trade for the event-driven strategy?

An expert in merger arbitrage has put some meat on the bones of those arguments risk arbitrage has not died a horrible, deal-less death

The Halcyon days of hedge funds making the classic carry trade are over, according to Albert Saporta, managing director of AIM&R in Geneva.

However, he added this by no means spells the end for the event-driven strategy, or the merger arbitrage sub-set of this strategy, whose epitaph has been read of late by more than one market commentator and fund of hedge fund manager.

"The environment has been extremely positive for financial markets and interest rates have been going down for the last 30 years, but it looks like this environment may be changing," Saporta told attendees at *Hedge Funds World Global Opportunities 2005* conference in New York earlier this year, in March.

The profitable carry trades hedge funds have been playing for the past 10 years are over, he added.

"A fund of hedge funds with a 10-year track record, producing 19% returns with 3.3% volatility and a Sharpe ratio of 5.8 – who could do this?" Saporta asked. "This was done by the 12 largest banks in the US. Over the last 10 years, banks would have consistently ranked as the top-performing hedge funds of all times.

"With all due respect, I would not have expected to have found the best traders in these places although they have produced the most incredible returns for 10-15 years. This can only be because the environment has been good to make money in general," Saporta explained.

"However, all the signs suggest the interest rates environment is about to change," added the managing director of the Swiss firm, which manages hedge funds and is an institutional research boutique.

The firm runs the S.O.G. Fund, a global multi-strategy event-driven equity arbitrage fund, as well as an Asian/Japan-focused equity arbitrage fund, and a Japan-only equity arbitrage fund.

AIM&R's S.O.G. Fund has compounded returns at 13% annually since its September 1999 inception, according to figures provided by Geneva's AIM&R.

## IMPLICATIONS FOR RETURNS

The result of rising rates and hence more expensive capital? "Hedge fund returns will go down in the same way returns in banks and financial instruments will go down if only because government short term borrowing one year ago were at 1% and five-year Treasuries were 1.52% but now they are at 2.5% and 3.78% respectively. Now it is costing a lot more money to borrow and set up any type of carry trade."

The result: declining returns from the asset class, according to Saporta.

"Hedge fund managers will take more risk and they have started to do that and managers will gravitate towards less liquid strategies, which is one of the reasons you see the popularity of private equity funds, and volatility will probably increase," Saporta said.

"Until now low and declining interest rates allowed managers to increase balance sheet exposure and to trade spreads. Now the increase in rates should mean increasing their balance sheets, but they should actually be doing things the other way round."

Event-driven managers should also be gravitating toward less liquid strategies such as high yield. Some funds' move into private equity will bring imbalance in investment horizons of the investors, and that of the investment, Saporta said.

The imbalance of investors' and investments' time horizons comes because a private equity investment may have a life of seven or more years' duration, while hedge funds getting involved may offer monthly or, at most, annual liquidity, if they have no longer lock-up provisions.

Lawyers note the typical private equity fund will raise money, close while investing it, and distribute funds to shareholders once investments are exited, anywhere from five to seven years later.

While some trading of private equity fund shares does exist on secondary markets, this is extremely limited and carries its own valuation issues.

"We do think we have to go to illiquid strategies, or do things differently," Saporta said, citing entry into non-directional markets where the opportunities "have not been arbitrated fully as yet."

## NEW OPPORTUNITIES

There do still exist opportunities in the merger arbitrage sub-sector of the event-driven strategy to make profits, Saporta said, via a number of tactics.

These are four: traditional trades in non-traditional markets, non-traditional trades in the main markets, traditional event-driven in mainstream markets, and non-directional event-driven in non-traditional markets.

Saporta's contention various types of trades in various types of markets still present themselves to merger arbitrage managers seems not only to counter arguments by detractors of risk arbitrage that deal flow has dried up, but also the argument that the deals that are there do not offer sufficient premium to make returns.

Saporta cited an example of a profitable trade that falls into the first category (traditional trade, non-traditional markets), as trading in Ambev shares, a Brazilian beverage firm which Belgium's InBev (then Interbrew) announced it wished to buy control of in March 2004.

"This would be followed by a cash or exchange offer without protraction to minority shareholders of the ON shares in the mandatory offer," Saporta explained.

From April 2004 to October 2004, for as long as the ON shares traded below the cash offer price, it was effectively a 'free call' on InBev, plus a 20% absolute return in Brazilian reais (35% in dollar terms), however some regulatory and currency risk did exit during that period.

"Up until the beginning of last week we could go into it with a 6% return, and risk-free, with one to two months to run," Saporta said.

The deal was risk-free, he explained, because the offer was structured as a cash or exchange offer and, bearing in mind Brazilian pension funds could not tender for InBev shares because they may not hold overseas assets, they became "natural sellers in Ambev."

The issue was not immaterial, with Brazilian pensions holding more than \$1bn of paper, making the opportunity too large for the

local arbitrage community in Saporta's view.

"As such the spread stayed particularly high even in the very last days of the offer (March 29) and even as the trade became virtually risk-free having received all regulatory and shareholder approvals," Saporta said.

## TRADITIONAL TRADES, NON-TRADITIONAL MARKETS

For traditional trades in unusual markets, Saporta cited Singaporean bank UOL, a real estate holding company with a significant stake in local bank UOB.

Changes in Singaporean law compelled banks to divest their non-core holdings. UOB was expected to rebuff a hostile bid by a government investment entity for UOL, with the firm trading at a discount of about 32% to the offer when the bid was announced.

"Given that most Singapore property stocks were trading at discounts of less than 10% and that UOB would most likely resist the (government entity's) offer, if only to avoid having Temasek control a large bloc of its shares, we thought that the offer would have to be substantially raised and/or UOL would have to restructure," Saporta said.

Saporta bought into UOL and shorted UOB to capture the real estate stub at a 33% discount. The offer was rejected, triggering a restructuring plan whereby UOB's shares were distributed and the discount narrowed from 33% to 24%.

"There is a second restructuring that will take place," Saporta said, "and we think VOL will become a real estate investment trust, and the whole discount will disappear. We made 20% in less than a year in a deal that was relatively simple."

## NON-TRADITIONAL TRADES IN TRADITIONAL FINANCIAL MARKETS

The final route to making profits is non-traditional event-driven in traditional markets, Saporta explained.

Swiss mini-conglomerate Forbo is such an example, Saporta explained, which became subject of an offer from private equity group CVC, and whose valuation Saporta was aware of as Forbo was undergoing a capital increase. Saporta calculated Forbo's shares were worth CHF324, and bought in when the first offer was made with shares at CHF200.

The firm announcing it would auction itself was a sign to buy in more for Saporta, before exiting at between CHF250 and CHF270.

"Because we were extremely familiar with the situation, prior to the first offer, having done valuation work when the capital increase had been decided, a small position had been taken after the first offer was announced," Saporta said.

"However when the company put itself 'officially' for sale, a significant position was built up as the shares traded for a while well below the initial range agreed between CVC and Forbo's board. We were convinced that the valuations of Forbo would justify offers toward the high end of the range possibly higher."

AIM&R consequently bought 2% of the firm, which at the time represented more than 10% of their funds under management.

"Close relationships were established with the board and other significant shareholders," Saporta explained, "and a final offer was made at around CHF 260 which was accepted by Forbo."

And the final rate of return on the deal? More than 25%.

#### A TREND TO CONTINUE

"You're starting to see most of what's happening in Europe is companies putting themselves up for sale and a bunch of private equity making a bid. As a hedge fund manager you have to find out is there value in the company," Saporta said.

A further opportunity presented itself to AIM&R in the Medidep/Orpea situation, in which Orpea, a nursing-home company in France purchased a 30% stake in Medidep, with the intention of buying the remainder at a later stage.

"Orpea has made no secret that it wants to acquire the whole of Medidep...and, as a result, the shares of Medidep have started to underperform Orpea significantly as the speculative interest dwindled, to the point where the valuation spread between the two companies is clearly in favour of Medidep."

"We are long Medidep and short Orpea, a relative-value trade with an embedded call option," Saporta said, expecting a rate of return of between 15% and 20%.

Saporta added merger arbitrage trade opportunities did still exist

inside the US – traditional event-driven in a traditional market – "most of the time where there is a perception problem in the deal or sector."

Saporta, for example, bought into the ATT and Comcast transaction, which offered a "huge spread" because the deal occurred when the telecom sector, in Saporta's words was "imploding and risk arbitrageurs were putting an excessive premium on any deal taking place in this sector," Saporta told attendees at the hedge fund conference.

This transaction represented the fund's largest position in July 2002, with more than 10% of its gross exposure committed to this deal.

"Until then the fund had a much smaller position long ATT/short Comcast, and short other US telco stocks to hedge the implicit stub," Saporta explained.

"The possibility to trade the when-issued stock changed the nature of the trade from a stump arbitrage/relative value trade to a merger arbitrage trade," Saporta added.

"By setting up a long ATT / short Comcast (in the parities of the broadband deal) position, one was buying the remaining ATT business (the stub) at around \$2.50.

"Yet this stub traded on a when-issued basis at \$3.75. This represented a 150% return on the stub part. The fund was long the same security at \$2.50 and short at \$3.75. Another way to see this was that this was a \$1.25 spread on a \$10 stock (ATT)."

The fund made 26.6% (annualised) on the deal, Saporta said, adding the US deals are the most profitable book in the fund presently.

#### NON-DIRECTIONAL, NON-TRADITIONAL MARKET

The final opportunity for merger arbitrage managers is a non-traditional event-driven opportunity taken in a non-traditional market, Saporta said.

An example of this is the Softbank/Yahoo (Japan) transaction, with the 42% of Yahoo Japan that Softbank owns, Saporta said, being worth more than Softbank itself.

"This is one of our largest positions," Saporta said, "and the Softbank/Yahoo Japan trade is probably one of the most attractive event-driven trades we can think of."

"Softbank was originally one of these internet incubator companies.

Out of hundreds of investments it scored two significant home runs: it backed Yahoo, and especially its Japanese subsidiary Yahoo Japan. However, in the last two years, Softbank has transformed itself from an internet holding company to an operating company.

"It has become the second largest broadband supplier behind NTT. It is also becoming a significant long distance telephone player and will be competing head to head with NTT in local telephony soon by

bundling internet with local telephony," Saporta explained.

"Implicitly the market is valuing these businesses since the stake in Yahoo Japan alone represents more than the whole market cap of Softbank." A Key competitor of Softbank, eAccess is valued at Yen 120bn with less than half Softbank's customers, Saporta noted, and AIM&R consequently believed at the time of Saporta's comments Softbank was trading at a 30% discount to its net asset value (NAV).

## Don't panic at falling alpha, Citigroup head counsels managers

The head of alternatives at Citigroup in New York has told attendees at the recent *Hedge Funds World Global Opportunities 2005* conference investors are adjusting their expectations to any decline in alpha generation.

Declining returns from hedge funds as the industry becomes more crowded with managers and trades should not necessarily be of concern to the industry, according to Neil Brown, managing director of Citigroup Alternative Investments, as he says investors have adjusted their expectations accordingly.

"If you look at the years 1999-2004, it looks as though the alpha generation is declining," he noted. "Should that be an issue? I feel investors are aware of it, and are factoring it into their decisions, and return expectations are about 400 basis points lower than they were," Brown said.

His words have been borne out by studies from Bank of America and Casey Quirk and Acito and, more recently, a landmark study conducted in tandem by KPMG and Create. For more on both studies see past issues of *Hedge Funds Review*.

"Innovators will always come and create the next wave of opportunity," he added. Many allocators – present and prospective – and some managers felt 2004 had provided less-than-adequate returns from "absolute return" products, a situation not helped by credit shocks in the middle of 2005.

Speaking at Terrapinn's conference, Brown said: "as capital flows into new strategies that are eroded the same we are that cases used to find more oil are exactly the same as what our industry will have to create in the next few years to become bigger."

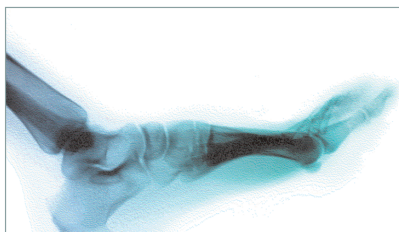
Brown cited examples of innovation in instruments such as credit default swaps or default trading, but he added "a lot of the alpha will be found outside developed markets. I am sure we're going to innovate as an industry as move into markets and geographies or instruments we have not seen in the past."

Brown said "growing up as an industry" was "all about who is the buyer of the product," and, as with other commentators, Brown predicted institutional interest would continue to grow in absolute return vehicles and, more specifically, in hedge funds.

"If the number (of assets coming into the industry) are close to some of the ones I have heard it will be an interesting time for the industry," Brown told attendees at the conference.

"But there are definitely some trends suggesting we should think about how we are structured as an industry and how we should respond to our institutional clients," he added.

*Please note: Neil Brown's comments were made before the downgrading of General Motors and Ford in mid-2005 by Standard & Poor's, and therefore do not take into account these later developments and the subsequent shock to the credit and fixed income markets, and hedge funds acting in them. For more on these actions and returns since Brown's comments were made see previous editions of Hedge Funds Review.*



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# Two to tango: how Latin American funds are luring investors with healthy returns

Latin America and Asia have been the regions capturing most of the attention of hedge fund managers lately. And with the former fuelling the latter's hunger for commodities, hedge funds are sprouting left, right and centre to exploit profitable opportunities

While Latin America provides some interesting investment opportunities for the local and offshore hedge funds investing in the region's growing range of instruments, experts are cautioning allocators to realise the region is anything but uniform.

Pablo Taussig, managing director, asset management at the Patagonia Argentine Recovery Fund, which invests in Argentine fixed income instruments, said Argentina had had a "deep depression" with the sovereign debt issue, and then a "huge devaluation" in 2002, but after the depression, in 1999-2001 there was a sizeable recovery.

"During this time there were very good opportunities in private sectors and the corporate sector had a very strong move after suffering the crisis and earning its revenue in pesos, with liabilities in dollars.

"We think furthermore there will be strong recovery in 2005. The swap of sovereign debt will be completed soon and after that we expect to see a convergence of margins in Argentina."

George Wachsmann, partner at Fiducia AM, said Brazil had experienced the recovery after 2002 and an election period, seeing growth re-emerge in 2003-2004.

He defined 2003 as a year of cross-sector performance, with 2004 more a stock picker's market, with commodity firms and cyclical moving against the local index, which is overweight telecoms.

The hedge fund industry has also experienced growth and maturation, he added. "At the beginning of 2003 most hedge funds were macro with some exposure to equities but then from the beginning of 2004 there was a huge boom in long/short funds, which account for more than \$1bn of the \$30bn in local hedge funds.

Wachsmann noted many managers who previously only offered funds locally were opening tax-exempt offshore versions. "If you compare the Brazilian industry with the US or Europe the Brazilian funds are much more institutionalised and most of them have come through distributors or big allocators. The industry is highly regulated by the CVM with the same regulation for mutual funds as for hedge funds."

## BRAZIL'S BATTLE AGAINST INFLATION

"On a macro level we are battling against inflation in Brazil with quite a successful outcome," he added, "although we do still have very high interest rates."

While Brazil's total fund industry, worth around \$300bn, has taken advantage of this growth, so too has the hedge fund community, with just under \$30bn under management.

De Campos said that despite the high coupon Brazilian bonds pay, he prefers equities. Hedging Griffo is currently most attracted to steel

on buoyant raw material prices, and industry consolidation favouring Brazil because of its low cost production.

He also likes petrochemicals with "strong positive momentum globally and high margins, and retail due to its growth from unemployment, credit and income growth.

"From the micro economic perspective our companies have very low levels of debt, are highly profitable and globally competitive in many sectors. After these years of high interest rates some of the companies ended in structures that are monopolistic in many sectors.

"If the country starts to grow you can find companies with a very competitive team for the next five to 10 years." Levi added the years of crisis had left a legacy of corporate management knowing how to react to bad times and shocks. "Interest rates going up in the US may take some liquidity from the local market but company managers will be prepared to deal with this."

Kreps noted the in Latin American spreads had come in to a level making companies on single-to-low-teen P/Es "exceptionally attractive." Kreps said Marathon would shortly be considering shorts in Brazil as well.

Levi added from a macro-economic perspective Brazil was passing through a period of income and credit growth "which is still very low in emerging market and global terms, and a moment when investment in the equity market is still low.

"People are used to high interest rates and the risk, but now they will have to look to hedge funds and other investments to continue to make their money grow."

De Campos added with the price of commodities high and rising, and the stock market standing at the beginning of a cycle of easing interest rates, now was a good time for foreign investors in Brazil.

With only 4% of total assets of Brazilian funds invested in equities, and a small share market compared to Spain or Portugal, two other logical destinations for local investment funds, Levi said there existed a "huge potential for growth" in locally listed shares as money flowed in.

Many local companies in Latin America also offer ADRs, noted Kreps, the popularity of which made Latin America in his view the most widely available region to foreign investors among emerging markets.

Levi said the best way to hedge in Brazil was, however, still to short the futures contract over the local stock, with 52 stocks offering daily settlement. "Equity loan in Brazil is a small affair and very expensive," he added, "and while the futures index still has the premium of interest rates which are very high when you sell the contracts you end up earning about 85% of the interest rate which is inside the futures contract."

De Campos said his hedge fund used the index future, while Wachsmann said he had also seen in the past Latin American market managers use other markets' derivatives – such as the S&P's and G7 nations' – to hedge positions in local markets.

Kreps noted local exchange traded funds (ETFs) were becoming increasingly liquid, with DWZs the Brazilian ETFs and DWWs the Mexican counterpart. "It is possible to go long and short various markets in Latin America via iShares," he said, saying this also opened the possibility of shorting a Latin American country against another nation.

## LEFTIST REVIVAL?

Levy noted on a political front there had been concerns when a Leftist government took power in 2002, "but as the government has shown there is no alternative to

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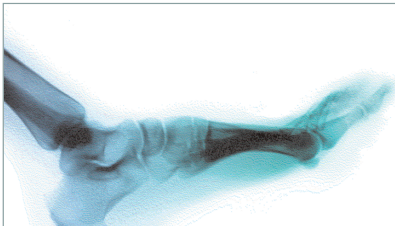
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sound economic policies this fear has gone away.

"The country may go through another political crisis, but it will not have so great an impact as it had before. We have a stronger currency and our trade balance has gone up to around \$160bn per annum."

Gary Kreps, chief investment officer at America's Marathon Capital Management, added: "I think emerging markets for the next five to 10 years have moved beyond the situation where a crisis will be induced by a cyclical uptick in interest rates. They are now on their own path of growth and managing their own economies."

Kreps said Latin America's reliance on offshore indebtedness has been "decreasing remarkably over the last three to five years."

"On a relative value basis looking at corporates and liabilities within sectors companies in Brazil are for the most part attractive on a global basis as well."

He added supplying China and Asia with raw materials was a "core driver" of earnings growth in Latin America, diversifying away from the region's reliance on North America.

"We feel commodity prices will run further and feel growth is not centred on the US, so the US can slow to half the rate it was growing at and growth can still be at 3% which will be a huge benefit to any country that has what China needs.

"The commodities cycle and boom is clearly pushing Brazil and some of the other countries toward a better stage," Kreps said, "but on the other hand you have the beginning of the interest rate cycle in the United States which brings liquidity fears."

Lavi noted, while high rates may be cause of concern for international investors, the local investment community was used to high interest rates. While any rise in rates may drain liquidity in the short term, he said this could also be positive if it pulls away capital that has flowed in seeking short-term returns and mis-priced some stocks.

"If we have a market correction with interest rates going up and liquidity coming back to normal levels and you have the right stocks in your portfolio at that time, the portfolio could enjoy

better years of growth," he added.

He said that Brazil had passed the sporadic years of "5% then zero growth" and is "moving to a more normal growth cycle."

George Wachsmann, partner at Brazil's Fiducia Asset Management, noted with Brazil celebrating 20 years of democracy the experience with Lula, it "looks like this is for good." Mauricio Levi, founder and chief investment officer at Brazil's FAMA Investimentos, concurred, but noted the risks lay in an international crisis hitting Brazil and Lula being unable to win re-election in 2006. "But if you look forward today you do not really see that on the radar," he added.

Ricardo de Campos, chief investment officer at Hedging Griffio AM in Brazil, noted some concerns Brazil was eating into

counted long before the crisis of default."

#### TO HEDGE OR NOT TO HEDGE YOUR FOREIGN CURRENCY EXPOSURE

De Campos noted that currency exposure to the Brazilian currency, the real was "no longer an issue, since you have some of the highest interest rates in the world in Brazil, at about 19%."

And even with such high rates attracting global money to the country, he added, Brazil still enjoys a positive trade balance.

"Our companies have not really made any big investments in the past few years so they are starting to take money from abroad and starting to make new issues in the US and Europe. This means the risks are on the positive side, and it's hard to see risks in money

"The experience with the left party has been so surprising for the market in terms of following exactly the same agenda the previous government followed in developing the economic structure I do not see that as a risk," Wachsmann said.

De Campos added, in Argentina which did default, they suffered very high unemployment, high interest rates, and decreases in GDP growth. "In two years unemployment went up from 5% to 25%," he said, "and there is no procedure to determine to countries that default, and we have now finished the swap process that had a 76% acceptance but nobody knows what will happen with the hold-outs."

"I do not think that can be considered a successful experience, although politicians may sell it like that in the internal market," De Campos added.

#### WORDS OF ADVICE:

"It is important to know the emerging markets well and they have always not provided a smooth ride so do not think the markets in Brazil or Argentina in five months will have doubled your money. It is a long term investment and be conscious of the risks you're taking. If there is a crisis in an emerging market everyone will suffer no matter where you are invested."

*Gary Kreps, Marathon*

**"Emerging markets have not always provided a smooth ride so do not think the markets in Brazil or Argentina will have doubled your money. It is a long-term investment."**

**Gary Kreps, Marathon**

reserves, at a rate of almost 15% in under one year, however added this was not the kind of problem to break the deal with the IMF. Levi added: "If the country needs the extra debt I think the government will not offer resistance to sign the agreement with the IMF. The old Left that said we should tear up agreements with the IMF is not strong now and if Brazil needs another debt they will sign a new agreement."

Gary Kreps, chief investment officer at America's Marathon Capital Management, noted the unpleasantness of any default - in Argentina, Russia or Asia - but added "after 10 years of crisis the market starts to discount the problem in securities pricing long before you ever have the full blown problem."

"In Argentina, for example, the securities were massively dis-

flowing out of the country," de Campos added.

The Patagonia Fund's Pablo Taussig added investors might expect a return from the country of 10%-20% for the coming two years "as the domestic dynamic is completely independent of the euro rate and other emerging markets'."

Levi noted if investors did want dollar exposure in their Latin American investments, futures contracts and non-directional forwards existed to facilitate this, however Wachsmann said he saw more investors these days looking for the local currency exposure.

#### WILL VENEZUELA DEFAULT?

The issue was raised, would the left government in Venezuela default on debt, but the managers at the *Hedge Funds World Global Opportunities 2005* conference felt fears of this were overplayed.

"There is a question of economies of scale - if you have enough size to put in place a local team to get a good knowledge of the market, such as Ashmore and Marathon have done, that is good, but you will need to have at least \$1bn. If you are just going to put \$10m in Brazil and \$15m in Argentina I fell that's a mistake because you will not have enough exposure."

*Pablo Taussig, Patagonia Argentine Recovery Fund*

"Buy a local fund of hedge funds."

*George Wachsmann, Fiducia*

"Do not think Brazil is just a bunch of plants and soya beans. You have to get a manager who knows what's going on. There are some things that need to be examined carefully and you need an expert to do this."

*De Campos, Hedging Griffio AM*

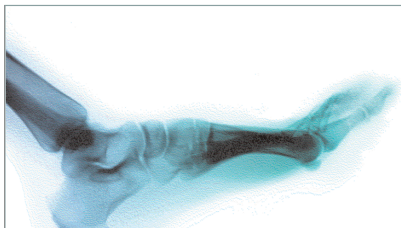
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Investigations into Canada's Portus fund have continued apace, casting a shadow over Canada's domestic hedge fund industry

# Portus: The maple leaf snag for Canada's hedge fund industry?

While Canadian hedge fund practitioners predict tighter fund regulation in Canada after Portus's demise, they have emphasised opportunities still abound in the 'north' of North America.

While the scandal at Canada's Portus Alternative Asset Management was more a compliance issue of alleged mis-selling than a fund melt-down, experts say it will still have the effect of keeping the minimum investment requirements for Canadian authorised hedge funds high.

Canadian practitioners at the *Hedge Funds World Global Opportunities 2005* conference in New York recently emphasised Portus was not in the strict sense a hedge fund, and that the issue did not appear to be one of a hedge fund "blowing up" a la Long Term Capital Management.

The assets of the fund have been seized by the Ontario Securities Commission, KPMG has been named receiver for the fund, and one of its directors, Boaz Manor, is believed to have left for Israel.

Bloomberg reported the fund had Can \$662m in assets, and Can \$1.1bn in liabilities.

Tony Sanfelice, president of information provider Canadian Hedge Watch, said the result of all this would be "the minimum investment levels will now stay high.

"I think as a result of this the Toronto regulator will definitely look at more products and whether different investments are suitable for certain investors, and this may slow down growth a bit," he added.

Portus, which specialised in structured and guaranteed products linked to hedge funds, was targeted by Ontario's financial regulator for alleged mis-selling and allegedly paying out more than Can \$87.6m in commission fees to third parties.

Ontario law firm Greg Monforten and Partners told Bloomberg this was more than 12% of the fund's assets. The investigation into Portus continues.

Miklos Nagy, chief executive officer at Quadrex AM, noted the company had taken in around Can \$800m in the past two years, and had "grown tremendously."

"Most likely the investigation

will have a big impact on the growth of the hedge fund industry in Canada and the type of products brought to the market...in the next three to five years," he added.

"There will probably be more regulation of hedge funds in Canada, although I believe regulation of funds is higher than in the US."

## CONSERVATIVE INVESTORS

"People in Canada are more conservative investors and the reason they like the guaranteed products is because of that word, 'guarantee'," Nagy said.

"After this investigation they will have to realise there is no free lunch and if you have a structured product even in the best case you have to pay the extra fees for it."

Nagy added the investigation into Portus may well also hit the area of fees structured products charge. "Many of the hedge funds brought to the market classify certain fees not as management fees. If you're reporting the management expense ratio (MER) of the fund and not including in the MER some of the fees that should be included, it could end up you're showing a certain MER that does not include fees which should be in it.

"Most likely the impact of this will be clearer rules about what can and should be reported to the investor in these types of products."

## TARGET MARKET

"The main difference between Canada and the US is in Canada the products are marketed to different investor groups," Sanfelice added. Depending on regulations in the province in question - as Canada has province-specific regulations and 10 regulatory bodies - since 2001 Canadian investors have been able to buy hedge funds for low minimum wealth and investment thresholds.

Presently to be allowed to invest in hedge funds, 'credited investors' need to earn either Can \$200,000 net

income, or hold Can \$1m net worth. This is less than the minimum hurdles investors in the US must pass, for example, to be allowed to invest directly in hedge funds.

Once an investor has signed a risk letter acknowledging they appreciate the risks involved in investing in hedge funds, they can invest as little as Can \$5,000 or Can \$10,000, making the distribution market a financial advisor-led affair with medium-worth families often the eager buyers.

"You need to make Can \$200,000 or have Can \$1m net worth to be able to invest Can \$10,000 in hedge funds but as long as you make Can \$70,000 or have assets of at least Can \$400,000 you can invest Can \$5,000 to \$10,000, which is one of the reasons I think hedge funds have exploded in size," Sanfelice said.

Structured guaranteed products, furthermore, allowed hedge funds to be distributed to anyone without checks on what kind of person the investor was, Sanfelice added.

## EARLY DAYS OPPORTUNITY

While the Portus affair somewhat overshadowed the broader opportunities found in Canadian hedge funds at the Hedge Funds World conference, practitioners emphasised the industry north of the US went much further than Portus.

Miklos Nagy, said the local hedge fund industry has come along in leaps and bounds, with around \$25bn under management, of which about \$16bn is retail.

Nagy predicted the regional regulation that holds sway in Canada would probably move more towards centralised regulation in the future.

Keith Tomlinson from the five year old fund of hedge funds firm Arrow Hedge Partners, said the 10 provincial regulators each represented "pretty much state of the art regulation" in hedge fund oversight, reflecting mutual fund regulation.

Tony Sanfelice said the centralisation of regulation would take some time to achieve. He said in the investor market structured products were very attractive to locals.

Tomlinson said eight of the 25 managers in Arrow's four funds were Canadian hedge fund managers and represented 38% of Arrow's total assets.

"Three of them can produce a 10% rate of return or better in a

month," Keith Tomlinson added.

"We are very focused on early stage managers which is why we have so many Canadian managers in our portfolio," he said.

"In 2005 we continue to be big fans of the equity long/short strategy and particularly with emerging market exposure. Those are the types of strategies we will be pursuing." Funds of hedge funds account for about 40%-50% of the assets in hedge funds in Canada.

## CAPACITY CONSTRAINED?

But, Tomlinson said, putting a lot of money to work in Canadian few funds was not always easy: "From an allocator's point of view there is the opportunity of many early stage managers. In 2000 there was only \$3bn invested in hedge funds in Canada," he said, "and early stage and small is what a lot of Canadian shops are about."

The second reason to consider Canada's hedge fund community, he added, was the breadth of the nation's equity and bond markets. "There is plenty of opportunities for arbitrage in the local markets, although certainly there is a resource bent to it," Tomlinson said.

He said while much of Arrow's growth had come from high net worth individuals, pension plans such as Ontario Teachers and the Quebec public plan had made investments in the industry as well. Ontario has recently announced it plans to increase its allocation significantly from the Can \$4bn (or 5% of its portfolio) already in the asset class, and expects to grow its allocation to 20% in the coming years.

Most of Arrow's eight Canadian managers are equity long/short, many benefiting from listed firms changing recently from a corporate to a trust structure, and arbitraging opportunities from this change.

## ROOM FOR GROWTH?

Nagy said he expected growth in Canada's hedge fund industry over the next two to three years to be similar to its growth over the last three.

"The growth of funds has been increasing by 40% although from a relatively low base," he explained. Along with the mutual fund sector in the country altogether there is about Can \$520bn.

"There is a lot of room for growth still left," Nagy said.

# Switzerland and London vie for top spot for launching new hedge funds, managers say

## Fund of fund managers and advisors are split on where suits start-ups best for investors and regulatory flexibility

While European onshore domiciles are expanding in number, with Malta joining the stalwarts of Dublin, Luxembourg and London, it is the established centres that continue to hold sway.

Ulrich Angersbach, chief executive officer at hedge fund advisory firm Sigla Zurich Finanz in Switzerland, has dubbed Zurich "one of the most liberal places when it comes to hedge funds," whereas in Geneva if you had one investor the community worked "quite closely together", so others could be easier to attract.

"You can also negotiate with the tax authorities depending on the canton and say, 'This is what I want to do how do you wish to tax me?'"

"It is a service you do not find anywhere else in Europe," he said.

While the UK – where around 80% of Europe's managers are based – may be a good location for US managers to use, Angersbach noted the tax situation can "become a little bit insecure."

While Austria and Germany are also quite liberal, in Angersbach's opinion, one of Angersbach's acquaintances had to pay about E400,000 to be authorised and up and running there.

"Also there are still a lot of things that are not totally clear yet, such as how to tax a short," he added.

### FAMILIAR FACE IN LONDON

Bonnefoy said the UK regulator, the Financial Services Authority (FSA) was "probably the most familiar with hedge funds in Europe and the service providers there are probably the most experienced in Europe."

"If you're American you will pay taxes globally so there is a huge tax advantage to you and if you're non-American you can manage your personal tax down to zero. Corporate tax in the UK is 25% in any case," he added.

"I would say on the tax and regulatory side Switzerland is good and your negotiation system is advanced and the Swiss are used to hedge fund investment on an institutional and private client basis. In France and Germany both the regulators and tax authorities are a bit more cautious.

"I feel the AMF in France is sus-

picious of hedge funds but that is changing as more derivative traders are moving into hedge funds," Bonnefoy added.

### GALLIC APPEAL

However Marc Potters, managing director, research at French systematic trading house, Capital Fund Management (CFM), said now the firm would "definitely start a hedge fund in France."

**"If you talk to the UK FSA or its Irish equivalent it seems these governments are servicing you as someone who wants to set up shop and pay taxes but with the Continental European supervisory bodies we expect more suspicion."**

Sy Schleuter, CAI Analyse und Beratungsgesellschaft

He said the government was in many senses pro-small businesses, including hedge funds and while some laws around set-up could be complicated, a Gallic flexibility could aid start-up managers.

"One issue we were discussing with the AMF is being able to access the market directly with electronic trading, which is not possible regulatorily. This is something we are discussing with the authorities and we hope they will make new laws to allow this," he added.

### GERMAN INDIFFERENCE?

Philippe Bonnefoy, independent advisor and director of Commerzbank's Cedar fund of hedge funds, says the German experiment has been "met with some limited success although 2004 was not such a great year for hedge fund performance."

Sy Schleuter, managing partner at Germany's CAI Analyse und Beratungsgesellschaft, says the

Germany as a jurisdiction for hedge funds has "changed beyond recognition. "From 1994 up to 2004 investment in hedge funds were penalised with a CGT of 90% and if there were no capital gains from the fund you still had to pay 10% on the substance of the fund. This stopped investment in hedge funds.

"Now having experienced the bear market the attitude to hedge funds has changed and the law passed at the start of 2004 has turned out because of its late introduction to be one of the most liberal laws in the hedge fund arena.

"There is no minimum investment (in funds of hedge funds) nor laws on who can invest, and no

They say, 'Tell us why we should approve you?' rather than saying 'How can we help you?,' he said.

"On the Continent we still have an unemployment rate of more than 10% and we want to pay taxes and employ people. For the management company I would pick London to start up in, and for the fund itself Dublin," Schleuter concluded.

Ullrich Angersbach also looked to Eastern Europe, where workers earn \$5 per hour, compared to west, just across the border in Germany, where the going rate for their colleagues is \$50. He noted only 23% of the wealth of Germany's big companies now is created by operations in Germany, the rest being outsourced outside the country's borders.

### MANAGER EXCELLENCE STILL WEST OF THE BORDER

Bonnefoy said Europe still provided some excellent managers, with around 33% of his portfolio he oversees committed to European managers.

Bonnefoy added the downsizing at investment banks in Western Europe – with the analytical community "vaporised" – on slashing of research budgets, have created swathes of the investment markets uncovered.

"This has been complemented, he said, by some of the bigger investment banks saying they will only serve the top 50 clients on the Continent," he said.

"If you are doing capital structure arbitrage or high yield or almost any event driven strategy and credit, the markets are amazingly exciting," Bonnefoy said.

"You have analysts inside credit shops or long/short managers are finding opportunities to be exploited, so we find Western Europe one of the most exciting places to invest" he added.

But, while a merger arbitrage fund could set up shop in London, Philippe Bonnefoy said, the differing accounting, tax and bankruptcy laws between jurisdictions mean you need local experts to find the inefficiencies creating the opportunities.

For finding investment ideas, Sy Schleuter said, Germany made good sense, sitting as it does between Western Europe and the emerging Eastern European nations joining the EU.

"Being in Frankfurt over the last

CGT after 12 months of holding the investment."

In exchange for offering so many 'concessions,' Germany's government has required transparency from product providers to a level of German tax reporting.

Nevertheless, CAI's third strategy currently being launched will probably not be a German product, Schleuter says.

"We have just gone through the process of comparing various places for managing and establishing funds. It does not look like our third strategy will become a German one because of the mindset of the regulator.

### BRITISH HELPFULNESS

"If you talk to the (UK's) FSA or its Irish equivalent it seems these governments are servicing you as someone who wants to set up shop and pay taxes, but with the Continental European supervisory bodies we expect more suspicion.

10 years has created opportunities in finding mid- and small-size companies. If this continues in the mid-cap area, being close to the companies is always helpful.

"If you have a San Francisco or New York manager doing the same thing, it then depends on how well they can get up at 3am."

#### OPTIONAL FUTURE

Capital Fund Management's (CFM) Marc Potters said one change in the European landscape in the future could revolve around the options market hedge funds use.

"Europe's, we think, are much more transparent than the United States, because in the United States you have stock and options exchanges competing with one another. This style is very good for fees whereas in Europe with one centralised exchange per country their rules are very transparent.

"In Europe options are still traded over the telephone and the markets only serve for settlement," CFM's Marc Potters said.

He added, for a systematic firm like Capital Fund Management which "just wanted to access the markets directly" European markets do not work. Such European barriers are a matter Potters could see changing in coming years.

#### MAXIMUM HEADROOM

Sigla's Ullrich Angersbach did note the importance of realising when enough was enough, and capacity was reached.

"We have seen especially when it comes to mid-cap and small-cap markets you cannot produce endless ideas and you cannot go with \$20m to a small cap name."

Angersbach said, Sigla could grow "a little bit more" from its present asset levels.

"I can see a traditional product coming in Europe where a traditional manager starts to employ some of the hedge fund strategies or instruments to get some kind of hybrid product," Angersbach added.

However not all managers believed hedge funds had reached their natural upper limit.

Bonnefoy said he could name mutual funds that ran almost as much money as the hedge fund industry combined.

"Although the amount in hedge funds is large even with the challenges in 1994-1998 the larger of the hedge funds were making 30%-

40%. Past 1998 the whole institutionalisation of the market has changed the industry and it is a question of can you make 5%, 7%, 15% and have no drawdowns.

"The institutions have a performance target and a volatility target which is completely different to how the business has developed. The funds are starting to do Reg D and private equity and they have limited capacity."

But Richard Leibovitch, senior investment partner with Gottex Fund Management in the United States, said other opportunities were opening up in Europe as technology developed largely for the US markets

nefoy contrasted the experiences he saw of Asia and Europe in the credit field.

"In Asia the opportunity to look at distressed and high yield allowed you to be market neutral and to sit very high in the capital structure and collect a huge coupon without having huge volatility to the underlying," he said.

"In Europe credit was the only one place to look for returns because it is the least efficiently priced part of the capital structure and it is being much more commoditised by credit default swaps and collateralised debt obligations and structured credit funds. But the pricing of a lot



Philippe Bonnefoy, Commerzbank

**"We are seeing credit trading and bank loan markets opening up and I see this as a huge opportunity. If the banks develop these markets there is a high chance of a lot of the technology being developed in North America for credit trading would develop into Europe and Asia."**

Richard Leibovitch, Gottex Fund Management (US)

moved West, then further West to Asia as well.

"We are seeing credit trading and bank loan markets opening up and I see this as a huge opportunity.

"If the banks develop these markets there is a high chance a lot of the technology being developed in North America for credit trading would develop into Europe and Asia," he said.

"I expect to see big growth in Europe, and there is a big chance credit could lead that growth," Leibovitch said.

Commerzbank's Philippe Bon-

nefoy of the instruments is still quite difficult," Bonnefoy noted.

"Research budgets being slashed at the big investment banks means there is not a lot of efficiency in the information being offered to the fund investors.

"If I see a company being taken over I will go to the credit guys first and then the equity team because the credit guys are looking at the whole company," Bonnefoy added.

Phillippe Bonnefoy has recently signalled his intention to increase exposure to Asian markets, looking beyond the traditional hunting

grounds of fund of hedge fund managers, of Europe and the US for underlying managers.

#### BONNEFOY TURNS TO ASIA FOR NEW MANAGERS

Commerzbank Securities is set to double the Asian exposure of the fund of hedge funds for which it uses Philippe Bonnefoy as adviser.

The group currently has around \$100m invested in Asia, but plans to double this, taking its total allocation to managers focused on investing in the region to 10%.

Bonnefoy told *Hedge Funds Review* he has already added two new Asian hedge fund managers to Commerzbank's fund of hedge funds, and is looking to invest with around 10 more hedge fund managers.

Bonnefoy said he plans to make initial allocations of \$5m-\$15m and then, depending on performance, increase this to \$15m-\$40m.

Bonnefoy is sub-advisor to Commerzbank's three funds of hedge funds, and to the Cayman Islands-domiciled Cedar Fund.

He is the head of Cedar Partners and the chief executive officer of Bahamas-based investment advisory company Comas Management.

#### INEFFICIENT MARKETS: THE BOON FOR HEDGE FUNDS

"Asia is an inefficiently priced market and we see an opportunity to make money there," he said. "Asia used to be a long/short equity place to shop but the region is now offering more complex strategies like credit and capital structure arbitrage.

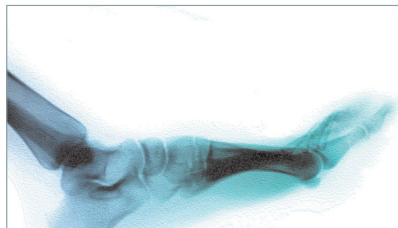
"The hedge funds there are becoming more investible for institutions in terms of size and risk controls.

"When an institution has more than \$1bn to invest it can't place \$1-\$2m with individual funds and it also can't account for 10%-20% of a fund's total assets," he added.

Bonnefoy and Commerzbank manages around \$2bn in hedge fund assets.

In support of this Asian initiative, Cedar Partners has opened a Hong Kong office with three staff initially, to perform hedge fund research and serve the firms base of Asian clients.

*Please note: These comments were made before the credit shocks of mid-2005, and incidents in London on 7 July.*



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**Hedge Fund & Investment Technology**

# US institutions more concerned with falling returns than funds imploding

US institutions are asking where the alpha will come from, whether a pyrrhic victory will result if their 1.5% allocation to hedge funds is the portfolio's sole performer, what will shake their colleagues out of hedge funds, and are hedge funds truly "monsters with five heads"?

US institutional investors at the *Hedge Funds World Global Opportunities 2005* conference in New York have placed blow-up risk quite low on their list of greatest concerns.

Higher up on their list was diminishing returns with greater inflows, high fees, and some consultants' unwillingness to recommend smaller and emerging managers. Institutions' own tardiness coming to the hedge fund party, in some cases, has also raised investment boards' eyebrows.

Brian Glanz from the Philadelphia Board of Pension and Retirement (PBPR), said the fund's US consultants CRA Rogers Casey had done an "excellent job" in helping PBPR decide on which hedge funds to use to make its first foray into the assets class.

"With the help of our consultants CRA Rogers Casey, we are looking at an allocation of 6% to hedge funds and we will go into funds of hedge funds initially. The first three investments will be funds of hedge funds and as we become more familiar with the asset class we will go the direct route over time."

The PBPR expects to make its first fund of hedge funds investment by summer's end.

## THE BIGGER THE BETTER?

But Glanz said some consultants were unwilling to suggest smaller or emerging managers for institutional investment.

"A consultant will not get fired for recommending a huge hedge fund, but I do not want our board to miss out if the better managers are the smaller ones," he said. "We need to get consultants to open up and look at the smaller groups but I do not know how much time they have to do that because there are 6000 funds out there."

PBPR's fund has around 60% of its \$4bn in equities, 25% in fixed income and the rest in alternatives, mostly (10%) in private equity.

Ultimately its allocation to hedge funds will come to about \$250m, of which a little less than \$200m will be via funds of hedge funds, Glanz said.

Glanz has dedicated one of the

three rounds going into funds of hedge funds for a smaller emerging group, by which he means less than \$1bn under management.

While Glanz said he could stomach an allocation of up to 10% or 15% in hedge funds he added politically this could be hard to get past the board.

(His was not the only voice suggesting weightier allocations to alternative investments. Michael Hennessee, managing director of foundation and endowment advisory firm Morgan Creek Capital Management, said the existence of "so many different strategies" of hedge funds and "so much talent" in alternatives meant one could "assemble a portfolio that is...55%-60% in alternatives and it will give you a much better risk return profile.")

"We rely heavily on our consultant," said Glanz, who is the sole body overseeing the hedge funds at PBPR. "I can't really go out and do a lot of due diligence. With our smaller staff I do wonder how we will get our emerging managers in and you have to really rely on your consultants."

## NOT LOSING SLEEP

Lawrence Powell, former hedge fund manager and now portfolio manager, strategically traded securities at the Texas Teachers Retirement System (TTRS) with one million beneficiaries and \$90bn, said many pensions' board members "spend too much time worrying about what the risks are."

"They're not allocating time to whether the positive aspects of everything are, whether the stock market or bond markets or hedge funds themselves."

"I do not spend time thinking about the risks of hedge funds, I could spend 90% of my time worrying about what the next hedge fund blow-up will be, or the next problem but is there any way I could protect against that? Not really."

Hennessee said his main worry was shortfall risk. "There will be some event but you should have some insurance against that in your portfolio and hopefully that insurance should not cost too much."

## SHORT TRACK RECORDS

Elizabeth Flisser from Capital Z noted that the incubator founded in 1998, had heard many of Glanz's concerns.

"Many allocators out there are not looking to managers with shorter track records, and we understand there is concern about headline risk with business issues," she said.

But she added there was research showing younger managers often found in emerging manager programs did perform better – "were hungrier" – in their early years.

## WHEREFORE ART THOU, OH ALPHA?

Powell said his main concern was the increasing difficulty in conducting the search for alpha.

Texas Teachers Retirement System has about 60% in equities, 30% in bonds and 10% to alternatives, of which about 4% is in private equity (targeted to rise to 6%) and 3% in real estate.

He said the 26 managers running their hedge fund money had represented 1.5%, or \$1.3bn, of the portfolio since the inception of the program in December 2000, and were spread across strategies bar global macro, commodity trading advisors and short only.

Powell said: "The respect I have for capital markets is huge. Resources have been marshaled in time. But the talent, energy and dollars spent searching for this alpha has diminished returns in a lot of areas and when you add fees on top it does reduce things."

Hennessee said alpha was, of course, "the name of the game."

"Depending on your size you can have 55% to 60% in alternatives, and as far as exposure to the traditional world, long only managers charge up to 100bps and you can get beta cheaply and easily in a liquid format.

"But alpha is the name of the game. I would love to see markets correct to the point when long only becomes a fat pitch but I do not think we will see that."

Hennessee said there was "almost

nothing" investors could do about blow-up risk, "if a manager wants to defraud you they will, but one way to do that is by manager size."

## TIME IS MONEY

Powell noted a further, straightforward problem inhibiting greater understanding of, or allocation to, hedge funds – time scarcity.

"There is not so much time in board meetings and I have talked about bringing in hedge fund managers. You have a situation where your allocating a very small amount of money from your portfolio and we already spend 80% of our time talking about 10% of our portfolio."

However Powell gave words of comfort to the hedge fund managers at the *Hedge Funds World Global Opportunities 2005* conference in New York: "I do not think you will get answers to these kinds of questions in traditional assets either."

## PHYRRIC VICTORY

Qui Vuong, chairman of America's National Association of Investment Fiduciaries, and himself a pension trustee, noted aptly it could prove a "pyrrhic victory" for pension managers if "it is only the 1.5% of then portfolio in hedge funds that performs."

Powell was mindful of hedge funds melting down, as well: "Hedge funds will blow up again and bad things will happen. I hope it will make some people exit from the industry because there is too much money flowing into some strategies."

"Last year was not terrible but it was not that great either and the question has to be asked about all the money flowing in."

"We have been investing in funds for a while, so we are not necessarily the Johnny-come-lately in the hedge fund world so we are the ones putting the money into the market and shoring up the opportunities and eliminating some of the opportunities coming in," he said.

"These are the problems out board is having with hedge funds and it is something that's a big issue for us, and the reason we are still at 1.5% allocation to hedge funds."

"The other problem is as a large institutional investor it is difficult to invest in managers with shorter term track records and we have a lot of complaints about short term track records performance."

Powell said the other issue was waiting for the "next hedge fund crisis," which he said would hit institutional investors "even more because of the large allocations we have made."

But Powell added it may not be the long/short allocations that get hit – if the crisis also hits equities or other markets more generally, Powell said, "the traditional investments that are unhedged will be the ones that will be impacted."

Glanz said his main concern was "getting to the game too little but too late and how do we justify the fees, which are quite high."

"If you get the kind of returns generated last year how do you justify them?" he asked.

#### HEADLINE RISK

The final concern he noted – which his co-panelists shared – was the "Enquirer crisis," or that a blow-up and pension investors' names will appear in the famous (or infamous) National Enquirer.

Some hedge funds may have been ruled out of consideration, as the Philadelphia Board of Pension and Retirement requires extensive transparency, not necessarily for its own purposes, as Glanz explained. "Transparency is an issue for us because we have the right to know laws, and a lot of hedge funds do not want to provide transparency and for any request coming in we have to provide information for them."

But Glanz said another concern over simple transparency came from many managers being "pretty vague about what they do."

"One of the issues from the sell side is managers being more open about their process. I want them to tell me exactly what they do. Why do you think you're better than everyone else? And why do you think you're worth 2% and 20%?"

"I am looking to be an investor but I do not want to be an investor in someone I do not understand. There are so many esoteric strategies out there I would like them to be a little more open."

Glanz added that greater access to the actual manager would be helpful. "If I had greater access to

the decision makers I could help speed the decisions up. At the moment it is difficult not to be vague to the board because the managers are being vague and that engenders trepidation when you're thinking about investing."

Powell said Texas Teachers Retirement System did argue the debate "if we don't commit at least 3% why do it all," but the mutual fund timing scandal somewhat overshadowed the discussions on this.

"Traditional pension funds are still looking at the traditional alternative assets, private equity and real estate, as areas they feel more comfortable with, and hedge funds they see as monsters with five heads. That's how they look at them," he said.

Michael Hennessee, managing director of Morgan Creek Capital Management, said the position of endowments and foundations was often different to that of his pension fund counterparts. Morgan

whereas our board is half made up of teachers, and the other half appointed by the governor."

He said, despite the board members' insight, there were still concerns about hedge fund risk.

"Ten years ago 80% of the money was in macro, today it's 80%-90% in non-macro strategies and there is the old perception still present one person has analysed an algorithm making decisions about whether to go long the pound or short the Nikkei, but that's not what hedge funds are about," Hennessee added.

"In 2001," noted Hennessee not without some ironic reflection, "it was perfectly okay to have 90% of your money in US growth stocks." Added Powell: "Or \$300m in Enron."

To avoid blow ups, he said, the fund must needs gravitate towards larger hedge funds with a chief operating officer, chief financial officer, risk manager and many analysts.

"I am not saying that is the only type of manager we can allocate to,

looking further afield but the wards of not constraining your group's focus are great, but it does put a toll on the travel."

Flisser said Capital Z's private equity manager stable exemplified the firm's global purview, with not a single US manager in it for its first three to four years. Now, she added, it has a heavier weighting to Asia, Korea and China.

"On the hedge fund side, we have seen some emerging funds come up in Singapore and Europe that are quite attractive," she noted.

Powell concurred with Flisser that a lot of the private equity managers the plan had been drawn to were outside the US, and about 30% of the TTRS fund was European, including managers in Sweden and London. The plan's first non-US hedge fund manager received money only in January 2005.

"But we do have hedge fund managers with offices outside the US and exposures outside the US," Powell said.

"We are seeing and exploring opportunities outside the United States," he added, "and I am a huge fan of geographical diversification not only throughout the world but also throughout the United States."

"There is a lot of hedge fund managers in Chicago and California and Texas and Boston and Minneapolis, you have too many guys in NY talking to each other and all of a sudden they're running the same kind of portfolio. But if you have managers in San Francisco or Minneapolis they can't do that."

Some of the managers noted problems in their not being allowed to accept offers of trips from investees, or potential investees, due to public sector law. Vuong noted

"We have an industry of hedge funds very dislocated with institutional investors who want to invest in hedge funds but they are being handicapped by the way they go about investing."

#### RETRIEVING TRUSTEES FROM THE CLOSET

Vuong noted the hedge fund industry was not doing enough to reach ultimate decision makers "who need to be the most educated."

"They're so afraid of appearing unknowledgeable and head in the closet and someone has to go into that closet and educate them," Vuong said.

**"Traditional pension funds are still looking at the traditional alternative assets, private equity and real estate, as areas they feel more comfortable with, and hedge funds they see as monsters with five heads."**

Lawrence Powell, Texas Teachers Retirement System

Creek Capital Management runs around \$850m.

Hennessee was previously head of the University of North Carolina investment committee, overseeing all asset classes from long only through private equity to hedge funds, conducting long term tactical asset allocation and manager selection.

#### SUPERIOR PERFORMANCE

"Most of the money is in hedge funds in all types of strategies because we think that is a superior way of running money because of the huge amount of intelligence to be gained in the asset class."

"In foundations and endowments lots of times you will have hedge fund managers and other chief investment officers on the board,

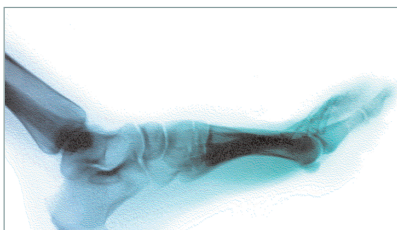
and we have recently allocated to two different groups in Europe and one has four people and about \$500m, and indeed we are gravitating away from larger managers as our portfolio matures," Powell added.

"I think I could put as much as 60% into hedge funds but not for our fund," Powell said, "I'm not sure there is enough capacity out there. We continue to educate our board about hedge funds"

#### GLOBAL SEARCH

Hennessee counselled allocators not to confine search for talent to the US – a suggestion made both explicitly and by implication of opportunities regional managers mentioned throughout the conference.

"It does make things harder



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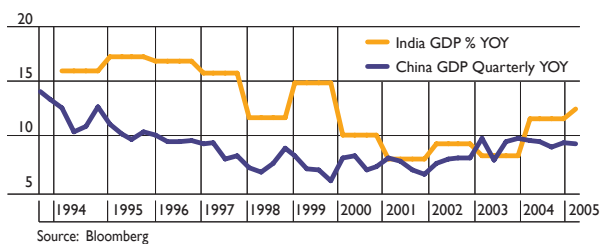
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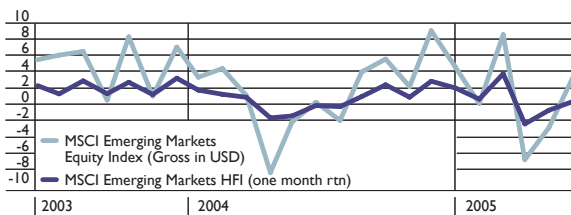
# A tale of two cultures... India or China?

With more than 40% of the world's population between them, India and China are also driving much of the world's economic growth. Although choosing between them is hard, it is important nevertheless

## YEAR-ON-YEAR GDP GROWTH %, INDIA AND CHINA



## MSCI EMERGING MARKETS HFI vs MSCI EM EQUITY INDEX



## EMERGING MARKETS: ASIA

	01/02/05	03/05/04	03/05/04	-- 03/05/04 --	02/05/05	02/05/05	02/05/05	-- 02/05/05 --	
	% chg	Rk	% chg	Rk	Volatility	+ Mths	- Mths		
Trophy Fd	2.18	9	104.44	1	18.34	7	5		
Kuroto Fund LP	2.59	6	25.75	2	4.72	8	4		
CITIC Capital China PI Fd Ltd	0.93	12	17.86	3	2.67	7	5		
Ashmore Asian Recovery Fd	5.08	2	17.24	4	0.82	11	1		
Senvest Israel Partners LP	-2.68	26	17.19	5	8.25	7	5		
Thai Focused Equity Fd Ltd	-3.04	29	13.67	6	5.21	6	6		
Stewart Asia Fund	0.67	13	12.05	7	3.99	7	5		
JMBO Fd	5.71	1	11.39	8	1.73	9	3		
GAM Asian Hedge US\$ Open	0.67	14	10.81	9	1.82	7	5		
Stewart Asian Holding NV	-0.95	21	10.59	10	4	7	5		
<b>Mean/Count</b>	<b>-0.03</b>	<b>33</b>	<b>10.1</b>	<b>28</b>	<b>3.76</b>	<b>6.89</b>	<b>5.11</b>		

Source: Standard & Poor's with underlying data supplied by Hedge Fund Research Inc. Calc basis: NAV-NAV, gross inc reinvested, US\$

China and India are ancient cultures, both still mainly impoverished, both mainly rural, each embracing change and both at the centre of hedge fund allocators' gaze.

James Breiding, managing director at Switzerland's Naissance Capital, notes this is largely where the similarities stop. "You have one economy which is service-based, India, whereas the Chinese economy is largely manufacturing, competing on the basis of cost. One democratic, the other autocratic."

Which you choose may not matter in one sense – China and India are predicted to grow attractively in coming years, building on impressive three-year stock-market growth, and both are set to play a major role in emerging markets outperforming.

## THE JEWEL IN THE CROWN

Pareesh Patel, managing director at America's Sparta Group, says the change in India is immense: "In 1991, India was a slow economy, importing most of its oil and capital goods, it had a shaky balance of payments and with a deficit."

Interest rates at 7% are at an "all-time low," he notes, with a consumer spending surge, retail borrowing at around 5% of GDP, capital available to invest in infrastructure, all of which positive changes have occurred since 2002. Mobile phone penetration at 1m in 1998, now grows at 1.5m monthly.

"These changes were not understood by the economists," Patel says. He adds opportunities in India are in both globally and internally focused sectors.

However, as Gautam Prakash from Indian long/short fund manager Monsoon Capital, says, risks are present – with liquidity among those that investors must take into account. With a domestic market capitalised at around \$410bn, daily volumes of around \$4bn-\$5bn and futures and options on thousands of the 10,000 public companies' names, diversification is one possible risk mitigator in India, potentially not so readily available to Chinese-focused managers.

"You have a large number of less liquid – or completely illiquid – names among the listed companies, so planning your exit can be difficult," Prakash says, "and liquidity

can swing in India wildly as the investment community move from optimistic to pessimistic and back." Managing volatility is, in the view of Paul Parambi from Kotak Mahindra Bank, a key risk that investors must control.

While Prakash says India's corporate governance – whether board make-up or audit committees – is "generally poorer" than it is overseas, he adds it has improved greatly since 1989-1991. "Corporate governance is one of the reasons we have a seven-person team in India to do more than read publicly issued financials of the companies," Monsoon's Prakash says.

Politically, India may boast the world's largest democracy, but as Prakash notes, in the past 12-14 years, India has had only one government serve its full term, and its disagreements with Pakistan have rumbled on intermittently.

## OUTSOURCING

"One of the main themes is outsourcing," says Parambi. Infrastructure is another. "India set to spend more on infrastructure in the next five years than in the last 60," he says.

Yet infrastructure is a selling point China has over India in the mind of Jim Rogers, co-founder with George Soros of the Quantum Fund.

"In India, it can take hours to make a simple journey and while it can sometimes not be a lot better in China, it is a real inhibitor to the nation of India," he says.

At the fund-of-fund level, many fund managers see China and India as two sides of the same coin – the former the world's manufacturer of the world, the latter providing many of its services.

"I think most investors are concerned with volatility, so from that point of view there is a real value added by having people playing the long and short sides of the market," says Jorge Corro from FMG fund managers. "We have decided to combine long-only with long/short, partly because there is a lack of managers to have a fund of hedge funds portfolio very focused on the hedge portion. As more managers launch, we expect to add to the hedge portion," Corro says. India has around 250 domestic mutual funds and 20-25 hedge funds.

These hedge funds can use the

single-stock futures market to find around 36 names with enough liquidity to short in the near month.

Shortly before the 27 February budget, says Patel, there was "huge short-selling" because last year the market took a hit, on a budget deficit, of around 23% in three to four days "so this time, a lot of foreign money built huge short positions.

"Then the news this year was positive and the long side went up massively and large and mid-caps went up even more drastically, which ruins your shorts."

Parambi says top-line earnings in India should grow at around 18% in the next year "so I believe the right thing to do is to get alpha on the long side and shorts can be used to reduce risk or generate incremental alpha."

## SHORTING ISSUES

"The shorts can be handled through index or single-stock futures with daily liquidity of about \$2.5bn. But a fund of \$150m, or at most \$300m, will find that is the most it can grow to," he adds. (The largest foreign funds in India, at around \$2bn, are long-only vehicles. "At that stage, you're unwieldy in this market," notes Parambi. "It is not a market that will attract hundreds of large global hedge funds," says Prakash, "and if it did, it would be a significant problem for India. You will have many funds with \$20m-\$150m, and often with their own niche."

Prakash adds: "If you believe India is going up over the next five to 10 years, and that it is a long-term opportunity, we are much more in favour of not buying insurance to dampen volatility, but finding mid- and small cap companies that are under-analysed and riding them for long cycles of their growth."

Parambi says a long-term view can make the picture particularly attractive, saying those with a three-year horizon could enjoy a 15%-20% annual growth rate, "but if you are an investor worried about short-term volatility, you would look to have that short in place."

However, US investors may invest through mainstream vehicles for tax purposes, registered with the authorities, and there will be restrictions on sector weights, which causes most problems in large-cap markets.

## CROUCHING TIGER

No matter what India's prospects, it has been overshadowed by the giant to its northeast. "Will Asia continue to grow?" asks Damien Hatfield, managing director of hedge funds at Australia's Pangana Capital: "I don't think you can stop it," is his response.

Suzanne Murphy, managing director of due diligence and business at Acorn Partners, says China is "probably the biggest economic growth story of our lifetime," but adds it is hard to make money from publicly listed firms in China.

"With China growing at 8.5%-9%, it is not so dependent on US consumption and the internal consumption in China is now the greatest consumption force in the world. Everyone wants the American dream," says Hatfield.

The path to this goal is likely to be smoothed by China's government, says Prakash, if for no other reason than to prevent internal social unrest.

"China's government will not do anything that will put jobs at risk. They will allow illegal goods to be produced, because it creates jobs and if you want to try to make an assumption of what China does, look through the social-unrest glass," he says.

Doug Barnett, president of Thai fund Quest Management, cites a potential social problem in China being a peasant population, who had largely stood up for Communism, now seeing their urban compatriots "getting rich in the cities. You have so many urban compatriots that is quite a worry if they get upset," he adds.

(Some commentators have suggested recently that the protests by some Chinese against Japan recently have been tolerated, at least, by the Chinese government, to divert attention from such internal problems facing the country.)

Barnett adds another event risk was any recurrence of the bird flu epidemic in Southeast Asia. Some managers running Asian funds from outside the region saw this as such a

trading opportunity on the flu's last widespread outbreak that they shifted their whole pan-Asian portfolios around to be ready for upturns after the instability the initial reports of outbreak engendered.

"Hopefully, none of these things will happen, but if they do there is a very long bias in Asia and Asian funds of hedge funds, so we are looking for managers with very specific alpha sources," Barnett said.

He said there existed "a certain complacency among investors as to the risks in Asia, so on the one hand we are trying to point out there are risks because everyone is quite sold on China, but we also say you had better step in with some caution."

The path to hedge fund managers' exploiting the markets in greater China have also, to a limited extent, been smoothed by changes in Taiwan, where the laws on stock borrowing have been opened up. Previously, says Edgar Chuan, managing director at Descartes Investment

## REVALUATION

China is likely to revalue its currency in the second half of this year, according to Francesca Fornasari, currency strategist at Morgan Stanley in London.

But the process is likely to be drawn out over a long period and is not likely to provide significant opportunities for profit, added James Bergin, director at Deutsche Bank Absolute Return Strategies.

Speaking at the Chicago Mercantile Exchange's Global FX Summit in London recently, Fornasari said the impact of the move is likely to be reduced by the numerous false starts there have been.

She said the Chinese government might be releasing misinformation to the market in order to reduce the impact the move will have when it happens for real.

A report published by Merrill Lynch's securities research and economics group argued a Chinese overheating and inflation problem

makes a revaluation necessary, and imminent. It will probably re-peg to a 5% trading band around a broad-based basket of currencies, it said.

It warned such a change could cause a wider change in the valuations of the entire Asian area currencies against the dollar. This could reduce the need for Asian central banks to acquire US treasuries and cause global liquidity growth to contract, with implications for risk appetite. On the other hand, it could provide a competitive boost for America, although, it added, "it will take a sustained under-valuation of the dollar to make a material difference to America's export market share."

The response of the dollar to media speculation that China's renminbi was about to be revalued offers no clues how the market will react when the currency does shed its dollar peg.

SOLOMON TEAGUE

Management in Hong Kong, going short was much harder.

The surge of money into China – long term investments and speculative capital seeking such opportunities – has surprised many and fuelled much of the nation's growth.

Since introducing its reforms in 1978, the Chinese government has overseen annual real GDP growth

buoyancy even in Latin and South American nations' economies due to Chinese demand, making many other plays not directly linked to China still dependent on continuing buying by Beijing of the world's raw materials.

Despite this, however, a Merrill Lynch report released in April from TJ Bond, the bank's chief Asia-Pacific economist, noted speculative inflows into China appeared to have eased in the first two months of 2005, compared to a fourth quarter surge last year.

Merrill Lynch estimations of speculative inflows fell to \$7bn per month in January/February 2005, down from \$18bn monthly in the final quarter of 2004. In 2004, the bank added, total speculative inflows accounted for around 8.1% of China's total GDP.

Adding to this speculative interest was foreign direct investment of \$60.6bn in 2004, up 13.3% on 2003.

"We expect foreign direct investment (FDI) to remain strong," Bond noted, "underpinned by the recent surge in new FDI commitments – a leading indicator of actual amounts – as well as China's undervalued currency."

However, Pangara Capital's Hatfield is not sure that Asia's China-fuelled boom will be captured by all hedge fund managers specialising in the region. "We have seen a wall of money hit Asian managers but I feel a lot of managers in Asia will have a hard time digesting that money they have received.

"There will pressure digesting it and getting it into the markets and a question will be around having the internal business systems to manage the money," Hatfield adds "In Hong Kong and Singapore, many managers will have problems with that."

## "A wall of money has hit Asian managers but many will have a hard time digesting it"

Damien Hatfield, Pangara Capital

averaging about 9.5%, from \$225bn to \$1.4 trillion in 2003, leaving China's economy as the globe's sixth-largest.

"The growth story is almost entirely domestically driven," said Tim Weir, director at London's Wessex AM at the *Global Opportunities 2005* conference in New York recently.

## COMMODITY BOOM

China accounts for around 25% of global demand for many commodities, more than doubling its proportional share of demand from eight years ago, and few expect the proportion to grow.

This demand presents a further opportunity for investors in the China story, one not as readily available to those seeking to tap into India's future fortunes – the ability to buy China growth by buying commodity producers in Australia or Canada, for example.

Some managers see a similar