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STANDARD & POOR'S

Greenwich Roundtable Quarterly

Exploring New Frontiers Of Investing

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Emerging Markets Redux

Inside this issue of *Stanrard & Poor's Greenwich Roundtable Quarterly,* we explore the emerging markets. We began our (re)exploration of these underdeveloped markets in the fall of 2002. The chill of 9/11, the bursting bubble, and a U.S. recession were beginning to lose their grip on our psychology. We began to contemplate asset classes or marketplaces that might begin to repair the damage our portfolios had suffered after the fall. Some were predicting a rally in U.S. stocks and some began to look for inefficient pricing in more unconventional markets. Russia was singing its siren song again. Brazil had new prospects for the seasoned investor. China was rumored to be in the midst of an historic economic revolution. And English-speaking India with her billions was also rumored to be on the verge of taking off. It was too tempting to ignore.

In China, we were treated to an eye-opening recitation of the unusual opportunities and the many risks that confront foreign investors. Jim Rogers, often called the Indiana Jones of investing, continued the bullish drumbeat he first started in 1996. In Russia, oil and inefficient businesses seemed to be the opportunity. Volatility and property rights are the risks. And establishing the rule of law is the challenge facing the reformers. George Siguler is the pioneering private equity manager who has experienced windfall profits and sudden collapses. Marshall Goldman is the skeptical advisor to governments and corporations who continues to be wary. In India, we examined an outsized opportunity with a great deal of caution. With the world's largest middle class population, its entrepreneur-friendly economy, and a will to improve its standard of living, India's prospects for profits seem limitless. However, its lack of infrastructure and its unwieldy bureaucracy pose formidable challenges to progress. Ambassador Frank Wisner is the highly regarded career diplomat who also guides external affairs for one of the oldest U.S. corporations in Asia. Ashish Dhawan is a successful venture capitalist operating in India who is setting the tone for private market investments. Samir Arora is a gifted stock picker and one of the few seasoned hedge fund managers on the continent.

Rian Dartnell led our head-long charge into the emerging markets. There was not a market where he didn't know the best managers or, at least, know someone who did. As a youngster, Rian lived in the Middle East and Europe with his parents. As an adult portfolio manager, he lived in South America and Africa. Rian's standard of excellence and his instinct for making money embody what we do well at the GR. Please join me in showing our appreciation to Rian for assembling this unique collection of emerging market essays.

The strength of the Greenwich Roundtable is our independence and our interdisciplinary perspective on investing. Our vitality comes from our members who are all seasoned in non-traditional investing. As we enter a new year, we still mourn the passing of Hunt Taylor. Hunt was a dedicated trustee and one of our favorite moderators. He moderated so many pioneering sessions and he did so with great flourish. Hunt loved the audience. And the audience loved Hunt. Hunt continues to live on in our hearts and our minds. *Vaya con Dios,* amigo. We will miss you with all our might.

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Standard & Poor's

Greenwich Roundtable

Quarterly *Exploring New Frontiers Of Investing*

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We have had our successes and our failures, but on balance it has been a positive experience. We look forward to investing further there for some fairly fundamental reasons.

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The Table Has Been Set And The Guests Are Coming To Dinner

Robert Citrone, Discovery Capital Management LLC | Aug. 17, 2006

Starting with the big picture, I believe that we're in the fifth year of a 15- or 20-year bull market in the emerging markets. When I say bull market, I mean substantial out-performance over the developed markets. I think that's going to happen not only in equities, but also in currencies and fixed income. It's going to happen in all the asset classes.

We invest in all of the asset classes in emerging markets, and I think it's helpful to be involved in all of them. But you have to realize that there is going to be tremendous volatility in certain periods. We had a 23% decline in emerging equities from May 10 to June 13. Within about a month, we saw significant sell-off not based on specific emerging market issues but rather a global risk reduction as well as a lack of liquidity and depth in some of the markets. This condition still exists so you have to be cautious because in the short-term, there could be quite a bit of volatility.

The reason why I think the next 15 years are going to be good for emerging markets is that the table has been set by 25 years of crisis. It started in the late 1970s with Latin American debt crisis, which in turn led to a bleak period during most of the 1980s as they tried to work through huge debt problems. There was a very short period in late 1980s and early 1990s when the emerging markets did very well and their equity markets got premiums in terms of their valuations over developed markets. But then came the Mexican crisis, the Asian crisis, the Russian crisis, the Brazilian crisis, and finally the Argentine crisis. I think the Argentine crisis marked the beginning of the bull market of emerging markets.

During that difficult period, many of these countries undertook major reforms that resulted in the following:

- Improved fiscal and monetary policies;
- Floating exchange rates instead of the fixed-exchange variety;
- More democratic, stronger, and freer institutions; and
- Open economies that more closely follow free market practices.

In addition, technology and communication have helped to narrow the differences between a number of emerging markets and the developed world, and have allowed them to continue to improve.

> The equity, currency, and fixed-income emerging markets will out-perform the developed markets.

The equity, currency, and fixed-income emerging markets will out-perform the developed markets, but there will be degrees of success. When you look at the emerging fixed-income external markets, and the Euro bond market, the spreads there have converged a lot in the past five years and the out-performance has been accentuated. There should be some small out-performance in the future because there is still room for additional spread tightening and credit improvement. But don't expect the substantial out-performance of the past.

On the currency side in general, most of the currencies are undervalued because of a number of devaluations over the past 25 years. There are very competitive exchange rates in emerging markets at the moment, and there will be real appreciation of those currencies.

When it comes to the equity side, we measure equities in terms of their multiples relative to developed markets at the moment. Therefore, we think that the discount is somewhere around 25% as opposed to more than 40% in the 2000-2001 period. I think in the next five years that multiple will go to a premium because growth rates are definitely stronger in emerging markets. In particular, domestically oriented companies will create a lot of value, especially those that serve the emerging market consumer and those companies that can benefit from the availability of credit at more reasonable terms. I think you're going to see a long period of continued deepening of credit markets in a number of emerging countries.

There are some countries where the ratio of private sector debt to GDP is less than 25%. I think that ratio will

rise, making for a much stronger base of consumption in many emerging markets, regardless of what some of the developed markets do in terms of protection. I think the outlook is very good for banks, beverage companies, and retail companies.

Now, for the risks. The biggest risk is political, because a political change can lead to an overnight change in the rules of the game or a significant retreat on reforms. We've seen examples of this many times in Latin America. While it's not as big a concern in the near-term, you have to be careful in China. The next significant downturn in China, which may be five years away or longer, is something to watch out for. The autocratic nature of the government might come under tremendous pressure in a very difficult economic environment due to the Internet and other communications technologies. The Chinese people know what's going on in the rest of the world and that could bring a lot of political pressure. Even though the Chinese economy has done well, politics is stifling reform. There aren't that many reformers at the senior levels of government.

The biggest risk is political, because a political change can lead to an overnight change in the rules of the game.

The second risk, especially in the short-term, has to do with any kind of sudden reduction in global liquidity. Studies have shown that the biggest thing that affects equity markets in emerging markets is a surprise shift in U.S. short rates. If people think global liquidity is being reduced, you see very large sell-offs given the lack of depth in some of these markets. If you told me the two-year yield was going to go to 5.25% from 4.86% next month, you'd see a pretty large sell-off in emerging markets. Even prior to the 20% sell-off in 2006, we saw two 10% sell-offs in a week, once in February and once in March. Both were related to a more than 15-basis point increase in the two-year yield. Any significant correction in the emerging markets over the past five to six years stemmed from a change in short-term U.S. rates. So pay attention to what is going to happen with rates in the U.S. as well as globally.

Protectionism is the third area that we watch very closely. If there is any restraint on trade and capital flows, the emerging markets will suffer quite a bit. I don't think it's a major issue at the moment, but as the U.S. economy slows down over the next few years, I really worry about potential trade barriers. We're already having trouble with the Doha round of trade negotiations.

Having focused on risks, here are some opportunities. In terms of equities, our three favorite markets are Brazil, Hong Kong, and Turkey. Those are very interest-rate sensitive markets. We think the interest rates have peaked and probably are heading down or at least will stay stable for a while.

Turkey had a 41% correction in its equity market in a very short period of time, and its fundamentals are strong. It's a significantly different country today than it was even five or six years ago. The continued integration of Turkey into the European Union, even if it doesn't ever obtain EU status, has been an amazing process. There's no doubt that Turkey has made the most change in a short period of time of any country I've visited in the past five to six years, and it continues to make very strong reforms.

As for Brazil, I would encourage people to look at the banks. We like Itaú Bank and Unibanco. I'd also look at consumer plays. In Hong Kong, we particularly like property. Sun Hung Kai is our favorite stock there. In Turkey, again, we look at banks. We like Akbank, Garanti Bank, and Doðan Holding, which is a media and energy company.

On the currency side, there are many interesting currencies in emerging markets. On a risk-adjusted basis, our favorites are the Philippine peso, the Malaysian ringgit, the Chilean peso, the Turkish lira, and the Russian ruble. Excluding Turkey, four have run very significant balance of payment surpluses, particularly current account surpluses. In Malaysia's case, it's 70% of GDP. I think they want a gradually stronger currency and will move as China begins to move. You don't have quite the yield disadvantage that you had in China but Malaysia has a little bit of an inflation issue. I think they're hesitant to raise rates and they'd like to fight inflation on the currency side.

On the fixed-income side, we think there are very good opportunities in Argentina, particularly in Argentine inflation-indexed bonds. Real yields are about 5% for short, five-year-and-under, bonds. Inflation is around 10%, giving a 15% yield, and we expect a relatively modest decline in the currency this year, maybe 1% or 2%. If they didn't intervene so much in the currency and allowed it to flow freely, it would actually appreciate. There is a chance you might see some appreciation, but I think they're going to continue to intervene heavily. Argentina is also one of the countries where we think the external debt spreads will tighten. So that's a good opportunity. We also like local rates in Brazil.

On the short side, we look at Korean equities because historically, when the U.S. economy slows down and the Fed begins to stop tightening, emerging markets generally do fairly well—with the exception of Korea, which is very growth oriented rather than interest-rate oriented. But also just looking at individual companies that we follow there,

we're beginning to see disappointments in earnings. We think there will be significant earnings downgrades in many Korean companies.

Korea had $4 billion in outflows from external investors and Taiwan had $19 billion in inflows. This is something that we've studied very closely, and it's one of the reasons why in 2005 we were very close to max-exposed in Korean equities. At the end of 2004, we knew the national pension system would be increasing its weighting in equities from 7% to 14%. The system had 30% of its assets in bank deposits of 30 days or less. It doesn't quite make sense. But we knew they were going to be doubling, and as soon as they did we knew that other institutional investors would do the same. What followed was that foreigners kept selling and the locals were the ones who repriced the market.

Korea has been a very cheap market for years. People always talked about the Korean discount but because of more investment by the locals, the discount has begun to go away. And in Taiwan, the locals are sellers. The local players in these markets are much more important than they were in the past. You can't just look at flows from outsiders. The improving depth in these markets will lead to lower volatility. It's a development that I think is quite healthy.

We also think the Russian oil stocks are overvalued. We're bearish on the South African rand. That's a good short. We would short the 10-year Hungarian default swaps. One particular company in Czech Republic, CETV, is very overvalued. It is now at 20 times firm value over EBITDA, and we think it's going to five times in the next couple of years. CETV has significant competitive issues in its home country and non-licensing issues in Ukraine. ●

Robert Citrone is a founding partner of Discovery Capital Management LLC, a $1.2 billion emerging market hedge fund formed in April 1999, and Discovery Americas, a private equity joint venture with Pedro Aspe in Mexico. Mr. Citrone has been advising and managing emerging market portfolios for the past 16 years.

He joined Tiger Management in January 1995 to head global emerging market investments. As a managing director of Tiger, he was responsible for the strategic investment recommendations on currencies, fixed income, and equities in emerging markets. Mr. Citrone originated the Emerging Market Fixed Income and Currency Group at Fidelity Investments in 1990. Over five years, he built the group to more than $7 billion in assets at its peak. During this period, Mr. Citrone managed the group as director, head of research, and fund manager for a number of emerging market mutual funds and sub-portfolios.

Mr. Citrone was a trustee of Hampden-Sydney College, where he served on the Finance Committee responsible for management of the College's endowment. He has also served as a trustee of the Tiger Foundation.

Mr. Citrone holds an MBA from the Darden School at the University of Virginia, where he graduated as a Shermit Scholar (top 10 in his class). He has an undergraduate degree in Honors Math and Economics from Hampden-Sydney College.

Nations Begin To Separate From The Pack

Ronald G. Percival, RGP Investment Advisors LLC | Aug. 17, 2006

Many investors have been uncomfortable with the pronounced market corrections over the past 20 years. From an historical perspective, there have been regular cycles of boom and bust, but the downturns have become less severe overall and have a shorter duration to the recovery period.

Many of the emerging market countries have continued to reform their economies and their political processes. In some cases, these on-going reforms strengthened the economic fundamentals and, as a result, these countries de-linked themselves from the emerging market countries where reforms have not been as successful.

It is important to note that the emerging markets began to create real interest for international investors following the September 1982 debt crisis that began in Mexico. It began in the fixed-income markets when the Brady bonds were issued to refinance the defaulted loans of overextended sovereigns and some private sector borrowers. Soon after these loans became securities, primarily issued from Latin America, Asia, and Africa, the banks began to sell them to investors at a discount. The market began to grow and investor interest deepened as countries reformed their economic, monetary, and fiscal management in an attempt to avoid similar crises in the future, with limited success.

The market began to grow and investor interest deepened as countries reformed their economic, monetary, and fiscal management.

Around the same time, the Berlin wall came down and the Soviet Union collapsed. This began the political opening of Russia and Eastern Europe to capitalism and free trade, in a limited fashion, and the fixed-income market there gradually began to grow to a certain extent. With the improved economic and political environment, the credit ratings of the more responsible and economically viable countries improved over the years. This, and the development of local capital markets, led to more private investment inflows that allowed a growing number of companies to issue shares locally to raise capital. Then they were able to do that on the foreign exchanges, mostly in the form of American Depository Receipts and Global Depository Receipts.

Most of the volatility in these markets in the early- and mid-1990s was brought on by one or more of the major emerging markets stumbling in the reform process and by external events such as the rising U.S. dollar or political upheavals in one of the large emerging countries. The adage of "if developed markets sneezed, emerging markets got a cold," was true—except that in this time period it was actually more like pneumonia. Even until recently, these countries suffered from contagion effects because they were viewed as a block, and what affected one always affected the other.

In 1994, Mexico was unable to manage its growing current account deficit, which led to a currency crisis and forced a major devaluation in December of that year. This threatened its ability to service its Brady bonds and precipitated a crisis that caused most emerging markets' debt and equity securities to fall significantly. Of course, the U.S. came to the rescue with a 20-year package of loans with some economic conditionality, pushing the Mexican government for more economic and political reforms.

I believe this is when some investors with a higher risk tolerance began to see opportunities in the Mexican market, particularly in the private sector. It gave rise to increased interest in further developing and participating in the equity side of the balance sheet. Mexico repaid those loans in a few years as the export benefits of NAFTA began to materialize.

In 1997, we saw a downturn in response to the Thai baht crisis. In 1998, there was the Russian debt crisis that caused

a global sell-off in emerging markets and forced spreads and debt servicing costs for these borrowers to rise substantially. The 2001 recession in the U.S. and the Sept. 11 attacks caused a major downturn in stocks and bonds in emerging markets, which was followed by the Argentine debt crisis in the fall of 2002.

These downturns all have similarities, but the market recovery time has become shorter as economic fundamentals, particularly in the major economies, has improved. There have been smaller market corrections since these major crises, but all have been followed by corrective action that created more economic expansion. For the most part, as the bigger and more viable emerging markets expanded, and the political systems opened up, they began to de-link themselves from the problems in their less fortunate counterparts.

The improved current account positions and growing international reserves have been generated by exports, particularly commodities.

In most cases, the improved current account positions and growing international reserves have been generated by exports, particularly commodities. This highlights one of the larger risks of emerging markets today—the slowdown of global growth and a decline in commodity prices.

Expansion in domestic markets within these countries also has contributed to recent growth, particularly in countries like China, Brazil, India, Mexico, and Russia. All have become large trading partners, not only among themselves, but also with developed nations. This trend should help sustain those economies in future downturns.

Many of these countries are now investment-grade or on the cusp. They've changed their debt profiles by repaying debt or retiring it early through buy-backs. Some world class corporations have emerged in these economies, including some of the world's largest oil, mining, manufacturing, consumer products, and telecom companies. Many are investment-grade, and many are hard currency earners, which acts as a built-in hedge for investors. Most of these companies still trade at much lower multiples than their global counterparts, and that is where there are a lot of under-valued opportunities. Both the fixed-income and equity trading volumes are much larger in these names. That has increased their liquidity to a much more comfortable level.

We have reached the point that when you do a top-down analysis on these markets—it's much more country-specific now. There are still many examples of countries not improving or moving in the wrong direction, such as Venezuela. This nation is a prime example of a country that had a lot of natural advantages and seemed to be going in the right direction but did a U-turn. The better emerging markets countries lowered their international debt levels, developed their local capital markets, and improved their corporate governance. However, risks in these areas still exist and have to be taken into context in any investment scenario.

In May and June of 2006, there was a major correction in these markets, but it was more in response to the global sell-off precipitated by rising short-term rates in the U.S. The correction was probably due for a technical downturn because the markets had enjoyed a three-year run. Both the Morgan Stanley Emerging Markets Equity Index and the JP Morgan EMBI had reached their all-time highs in February or March of 2006.

The markets stabilized somewhat in July and August but remain volatile and continue to be preoccupied with geopolitical events, particularly in the Middle East. These events may have exaggerated the existing concerns over higher interest rates in the Organization for Economic Cooperation and Development (OECD) economies and inflationary energy prices, but were helped by the Fed's hawkish statements in June and the rate pause in August

We continue to see political growing pains in these countries, as illustrated by the recent close election in Mexico. Mexico moved to democracy recently, and there is some dissent now, which you never would have seen 10 or 15 years ago. This is probably a good thing, but on a short-term basis it can cause some uncertainties. Even though Felipe Calderón won the election, the opposition staged protests that resulted in some increased uncertainty in that market.

In Brazil, a country that we like a lot, both candidates in the presidential election were perceived to be investment-friendly. Brazil's economy continues to grow and it has done very well. Brazilian interest rates are lower than they have been in a long time and they continue to decline. The government recast and rationalized its debt profile, and recently reported record trade surpluses. But in the longer run, the new government is going to have to address the excessive government spending and the pension issues in order to sustain growth and reform.

In Central and Eastern Europe, you have free markets that also recovered during July. The Russian fundamentals seem to remain positive, even though some of the Russian oil companies seem somewhat overvalued. A rating agency recently upgraded the country's rating to 'BBB+' and that was followed by the upgrade of many of the Russian banks. While several of the smaller countries in Central and Eastern Europe, particularly Turkey and Hungary, are facing political difficulties. In other places, you've seen some difficulties in forming ruling coalitions, such as the Ukraine and Czech Republic.

Asia was down slightly in July, recovered a bit in August, but was much less volatile than in May and June. China and the people who make and sell things to China are going to continue to be one of the major stories there. The weaker global technology outlook depressed many of the Asian technology-related stocks, but a lower global interest rate scenario—if that is what is next—will help the sector. Moderating growth in China has also tempered regional growth. Then there are the geopolitical events, such as North Korea's missile crises, that are going to cause volatility in those markets in the short-term. Yet, we think that Asia will continue to be a major growth story overall.

Our current strategy is focused on companies in emerging markets that will continue to do well in a slower global-growth scenario. We expect some uncertainty and volatility in the markets in the short-term because there is concern about the severity of this global downturn as well as the ongoing negative geopolitical environment. The extent of the slowdown probably will be a little easier to tell when we figure out what the OECD central banks will target for their respective interest rates, particularly the Fed. This is very important to emerging markets, because much of their substantial outstanding debt is denominated in dollars or other hard currencies.

In the medium-term, we are bullish on all these markets, particularly Eastern Europe, Latin America, and Asia. Some sectors should continue to do well even in a slower growth environment because of a growing middle class and, consequently, much more domestic consumption. Those are the markets and types of companies where we will try to position ourselves. The other ones are probably the markets to avoid or, if not avoid, find the appropriate shorts.

When I mentioned to my 10-year-old daughter the topic of my speech, her first reaction was "Gee, dad, that's boring!" And then I thought to myself, "You know, maybe that's the goal of these markets—they ought to try to become boring." ●

Ronald Percival is the founder, managing member, and CIO of RGP Investment Advisors and RGP Capital Management. He has 28 years of experience in emerging financial markets, particularly Latin America, where during the 1980s he was involved in the sovereign and corporate debt restructurings. During his career he has developed an in-depth understanding of debt and equity capital markets, corporate finance, and risk management, and gathered both primary and secondary emerging market debt trading experience.

Prior to starting RGP in 2001, Mr. Percival was the director and head of Latin American Loan Capital Markets and Syndications at Credit Suisse First Boston. From 1994 to 1998, he was a managing director at ING Barings during which he had responsibility for emerging market fixed income, equity and loan syndications. During the previous 18 years, he held various positions at Chemical Bank and Chemical Securities in emerging markets, including head of sales and new issue underwriting and country manager for Mexico and Venezuela.

Mr. Percival holds an MBA from Thunderbird, American Graduate School of International Management and a B.A. from the University of Texas at Austin. He is fluent in English and Spanish and has a working knowledge of Portuguese.

Risks Still Remain, Especially For Equity Investors

Lucia Skwarek, Greylock Capital Management LLC | Aug. 17, 2006

The original topic for this forum was the "Best of Emerging Markets" which got me really enthused, since for most of my career, people always seem to want to talk about the worst of emerging markets. However, I suppose after May's well-publicized sell-off, it was only prudent to change the title to the much more sobering "Issues And Outlook On Emerging Markets Investing."

I admit that the "worst" of emerging markets is very entertaining. We have soap opera scandals caught on videotape with suitcases bursting with money, wives trying to kick husbands out of the presidential palaces, and heads of state with stashes of cash in Swiss bank accounts. You can also throw into the mix current account deficits, devaluations, and currency controls. These are just some of the risks that are present in the emerging markets.

As conservative managers, you probably think you might not have much, if any, allocation in emerging markets. However, after a cursory review of a number of SEC 13F filings of mutual funds and hedge funds, I would encourage you to double check. You should grill your managers on exactly how much emerging markets exposure they have. In my research, I found mutual funds and global macro hedge funds that carried as much as 15% of their portfolios in emerging market stocks, even though they listed their geographic breakdown as Europe, the U.S., and Japan. What they had in their portfolios were American Depository Receipts and country funds that traded on the New York Stock Exchange. I suspect they're classifying those instruments or stocks as U.S. risk but they have the same exposure and currency risk as local shares.

It reminds me of 1995 when Mexico devalued its peso and a large North American government income fund lost 30% of its value because of its Mexican T-bills holdings, which were technically part of "North America" of course. Unfortunately, the fund had to go to its parent company for redemption capital. So even if you think your allocation for emerging markets is low, again, I would double check.

That observation brings us to what I think is the biggest issue of the asset class—its inherent cyclicality. Today, it seems we're riding one big virtuous wave of emerging market improvements with better corporate balance sheets, more stable governments, and more independent central banks. We've come a long way from the worst, and now we're approaching the best. You can see that in Mexico, Brazil, and Russia, which have essentially no external debt outstanding and high reserve levels. Current account deficits in most countries have turned into surpluses, elections have been held without the usual economic upheaval, and liquidity has improved significantly.

> We've come a long way from the worst, and now we're approaching the best.

Maybe all this success is the problem for the markets. Since the financial, call them "countable," risks seem to have decreased, the more qualitative risks like politics and reform get harder to measure. It's difficult to figure out what the next stage might bring.

I think that there are still significant risks in emerging markets, especially for equity investors. These risks go beyond reserve levels and Standard & Poor's ratings. The risks deal with the second and more difficult phase of development, of real institutional, pension, and labor reform. The emerging nations' weak local capital markets and judicial institutions, and even just the division between rich and poor, have to improve if we're ever going to get rid of these familiar boom and bust cycles. Today's improvements measured by drops in inflations, robust reserves, and lower lever-

age are real, but neither economic development nor equity prices move in a continuous straight line. Although it's less likely now than 10 years ago that we will get a financial crisis like the ones we've usually seen, it isn't impossible that we'll go from boom to bust once again.

Unfortunately, many investors tend to stand on the sidelines while emerging markets rack up spectacular returns from a bust-to-boom recovery; most investors only get caught in the nasty boom-to-bust part of the cycle. Understanding cyclicality, how things change, why they change, and the durability of the changes is key to long-term performance.

Country risk is my number two issue. Country risk is more than just S&P ratings and it's more than bond spreads. It defines the environment of the companies that you invest in. Country risk is politics, reform, corporate governance, and monetary policies. In every bust we hear about the instability of the political and economic environment. In every boom, we have euphoria. We're told how these markets are no longer emerging and that, because of their growth, they actually deserve a premium to developed markets. I'm beginning to hear these things again, and I'm also beginning to hear the stories about how there are no more country risks and that there are only company earnings. I've even heard people say, "Maybe emerging markets aren't even an asset class anymore. They've graduated." I remember a large U.S. bank said something similar just weeks before Argentina devalued. Honestly, I think euphoria has worked as badly as pessimism.

So what does work in emerging markets? I believe that successful emerging market investing requires three things:

- One, the ability to go long and short to match the cycles;
- Two, an understanding of risk and the ability to price it; and
- Three, constant checks to contrast and compare investments across markets.

It requires, especially in equities, a mindset that looks beyond what normal equity investors look at. It requires that you look beyond an earnings growth projection that could vaporize in a bad scenario. This mindset has to look at all politics, corporate governance, management, culture, (things that are very hard to measure), and in order to define if a market or a stock is priced for its environmental risks.

The way I look at emerging markets is a blend of top/down country analysis meets bottom up stock picking. I begin by looking very carefully for warning signs at the macro level—fiscal deficits, political change, and deposit movements among the local investors. I like to find a growing local investor base that creates an underlying demand for capital markets, rather than just foreigners owning all the markets. I like to understand each country's process for reform and regulation and how that might change and why. Then I study the relative price for each country's market and how market analysts go about setting that price. Do they have reasonable assumptions for foreign exchange rates, interest rates, and growth? It is only after I have a decent idea about what all the "macro" risks are and how people are pricing them that I look at buying or selling a particular stock.

You have to pick the right stock, but I still think it's more important to pick the right country.

Stock picking is clearly important. You have to pick the right stock, but I still think it's more important to pick the right country. At different places in the cycle, you can focus on earnings and multiple expansions. At other places in the cycle, it's more important to focus on companies in countries that have improving macro situations and represent some kind of value rather than momentum or the belief that this particular market is doing so wonderfully. Avoiding momentum will help you avoid the euphoria.

Some of it is just common sense. In April, analysts were using a 10% discount rate to measure Russian equities. I think Russia deserves a higher discount rate because there are large corporate governance issues and large institutional risks. I didn't mind those risks so much when my discount rate was 20%, but at 10% I think Brazil offers better upside.

Another example of country risk and how to price it for equities can be found in Mexico. Mexico's macroeconomic situation is fantastic. Most of the problems that historically plagued it—a weak central bank, high interest rates, and high inflation—have all converted to a stable economic environment and a developed local capital market with good domestic demand, not to mention a strong, creative, and independent central bank. But the politics are getting complicated. The opposition party and its leader do not want to give up, and that could hog-tie the government, which means no reforms on the energy, labor, and pension fronts. A political stalemate can affect consumer spending, delay needed infrastructure investment, and delay new investments. It's a political development but it all boils down to a matter of economic growth. Do you buy a market that has really great companies with little margin for error and is trading at the very top of its historical trading range? Or do you look for better value elsewhere?

In conclusion, the risks in emerging markets have changed over time and investors are certainly less exposed to large-scale financial crises than at any time in the last 10 or 15 years. We are in a secular trend of high reserves, low leverage, and better governance, but I think that there are caution lights.

The countries' development, in terms of politics, labor reform, and corruption, are still far short of the financial successes. It's very likely that central banks may have managed themselves backwards. They may have prevented a 1980s- or 1990s-style financial crisis, but also inadvertently planted the seeds of a new crisis—political and social—that may affect economic and earnings growth.

I do believe that there is still significant upside in a lot of these investments, but the easy money of the recovery and boom phase is over. The next stage of the cycle will be more difficult because markets will not move in lock-step the way they have in the past. Country differences are starting to take shape, as you can see in Turkey, Indonesia, and South Africa. Even in currency, bears are beginning to go after India, the well-loved emerging market country of the last couple years.

Global emerging market investing still requires that an investor incorporate country risks, understand how they change over time, and price those risks. Investor should remember that nothing occurs in isolation. Capital is truly global now, even for local investors. I would encourage investors to work through the arguments of euphoria to figure out if prices are what they should be for the risk that they take. ●

Lucia Skwarek has more than 20 years of emerging markets fixed income and equity experience. She currently manages the Greylock Emerging Markets Equity Fund (long/short) with a focus on value and distressed companies in emerging markets.

Prior to joining Greylock in May 2005, Ms. Skwarek spent 13 years with JP Morgan, first in Mexico City from 1983 to 1989 as a banker, then from 1989 to 1991 as a trader in Emerging Markets Group focused on Mexico, Chile, and Poland. In 1991, Ms. Skwarek began trading Latin American equities in addition to fixed income. By 1993 she was JP Morgan's head trader for trading Latin American equities. Ms. Skwarek was named "Emerging Market Superstar" by Global Finance magazine in 1995. That year she joined Union Bank of Switzerland to set up and run the Latin American Equity Department (sales, trading, and research).

In 1996, her newly established group at UBS received the Reuters award for "Best Trading Desk" and runner-up in Economics Research for Emerging Markets. In 1998, Ms. Skwarek returned to JP Morgan to manage a long/short portfolio of $300 million in Latin American equities and bonds and certain European and U.S. equities in the proprietary trading group. In 2001, Ms. Skwarek joined Violy and Co., a private investment bank, to focus on capital raising and private equity transactions for Latin American companies. In 2002, she continued to consult for Violy and Co. and others while she took a family sabbatical.

Ms. Skwarek received her B.A. in Rhetoric from the University of California at Berkeley in 1982. She is fluent in Spanish.

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A New Century And A New Economic Power

Jim Rogers, Adventure Capital | July 24, 2003

The 19th century was the century of the U.K. The 20th century was the century of the U.S. The 21st century will be the century of China. I advise everyone to learn Chinese. Like it or not, China is going to be the most powerful country of the 21st century. They are the largest country in the world right now, with 1.2 billion people and a landmass slightly larger than the continental 48 states. It's a dense population with a lot of issues and events now developing.

Despite the fact that they call themselves Communists, they are the best capitalists in the world right now. They are growing by leaps and bounds. It is very difficult to make money in China, especially for foreigners. The people who are going to make the fortunes in China are the Chinese. There's little question about that. They have a level of hubris that rivals our own. The Chinese really think they're better than the rest of us. They may be—I don't have a clue who's better or who's not, but I do know that they are reserving most for themselves. Yes, some of the foreign companies there are starting to make money. But it's been a long, hard slog for most of them. If you're thinking about doing something in China, be sure you have a Chinese partner—a strong Chinese partner. Be sure, if you can, to learn Chinese or make sure you have people who you trust that know a lot about the Chinese culture.

Despite the fact that they call themselves Communists, they are the best capitalists in the world right now.

Just keep in mind that it's the same way in China now as it was in the U.S. 100-125 years ago. We fleeced all the foreigners. They came here, poured in huge amounts of money, and we took them for a ride. Most of them went bankrupt. Most of them lost their shirts. We made a lot of money. You can't believe how much money

Rockefeller, Morgan, and Carnegie made off the backs of foreigners. That's pretty much the way it's been throughout history—a lot of countries have done it. Investing is not an easy process. Never has been, never will be. People talk about how easy it was once upon a time. I never remember it being easy! I've been in the investment world for 35 years and every week was hard for me.

Out of all those companies that came to America 100 years ago, some lost a lot of money, but if they stayed and learned how America worked, some made a great deal of money. Remember, at one time there were 3,000 automobile companies in America. There are now two-and-a-half. There have been several thousand airplane companies or airlines in America in the past 100 years. Most of them don't exist anymore, but some actually made it. It isn't easy getting rich in America or China or anywhere else. It is a very complicated and difficult thing to do. But China is going to be the great country of the 21st century.

In the U.S., as we expanded and grew, we moved west. It was a social release for American population pressures and it was a supply of great natural resources we desperately needed. In just the same way see Siberia as one of the great frontiers of the 21st century. All of Siberia was Chinese until the Russians started moving out there. Siberia will once again be Chinese someday—not necessarily by war, but by encroachment. It will relieve social pressures and it will help relieve the desperate need for natural resources. The Chinese are already one of the world's largest customers.

They're a huge exporter, but they're also becoming a gigantic importer because they need just about everything in order to manufacture all their products. Siberia has a vast amount of natural resources for which the Chinese are desperate. Siberia needs capital and manpower. There are very few people up there, so Chinese labor is moving into that vacuum. All through Siberia, there are Chinese farmers, tire shop owners, restaurant operators, and just about any other kind of service provider. Japan, which has huge amounts of capital, is also moving into Siberia. Chinese labor and Japanese capital are filling the Siberian void while exploiting its substantial amount of raw materials.

I'm of the view that China's not going to be a terribly aggressive nation; they're going to be unbelievably commercial.

My experience in China is that human rights are evolving and opening up. The situation is certainly better than it was 20 years ago. I have been in Christian churches in China where they didn't think they are oppressed; their minister is paid for by Beijing. They have Christmas carols; they have songbooks; they sing Christian hymns. Every temple is packed. Every mosque is packed. If the people's religious freedom is being suppressed, none of them seemed to know it or care. Oppression of the Falun Gong does exist—I'm not quite sure about the specifics of the problem. But even in this country we send people to jail for their religious activities—take Reverend Moon, for example. He's a Christian and we sent him to jail.

Of course there are problems in China. There are going to be huge setbacks. If you'd invested in the U.S. in 1903 you would have seen all sorts of problems: women couldn't vote; black people couldn't vote; there was no rule of law. You could buy and sell congressmen (you still can buy and sell congressmen, but in those days they were a lot cheaper). There was virtually no regulatory authority in the U.S. It was all political. By 1907 the whole country was broke. Washington and Wall Street were broke; the whole thing was falling apart. Somehow or another, the U.S. went from being a gigantic debtor nation that was essentially a marginal little place in the 18th century, to the richest, most powerful country in the world.

That's going to happen in China, too. I'm of the view that China's not going to be a terribly aggressive nation; they're going to be unbelievably commercial. That's the way they see their future and China hasn't had a long history of aggression. China's had a one-child policy for over 20 years. It's changed recently, but they still feel the effects of the policy. In a country where everybody has one child and one grandchild, they're not as likely to send that one kid off to war.

We read a lot about Japanese and Chinese antagonism historically but from my experience, it exists more in the Western press than in China. The single largest second language in China right now is Japanese, because that's where the money is. Twenty-five or 30 years ago, the largest second language was Russian, and then it became English. I'm not too worried about the Japanese and the Chinese going to war—not for a long time, anyway.

A recent major change in China's equity market is that the B shares (those available to foreigners) have doubled or increased two and a half times since 1998. I bought up a lot of B shares in 1999 because they were so cheap. The shares were given away because disillusioned foreigners had dumped them. Lo and behold, they are up now—up mightily. It is possible to make money in China in the investment markets, despite what you may hear or read.

One of the best ways to make money in the Chinese market of the future is to figure out how to play on one of its most serious problems. A great shortage of women is developing in Asia. For example, in South Korea right now, for every 100 14-year-old girls, there are 120 14-year-old boys. In parts of India, the men can't find wives. Last year in China, the statistics showed that there were 117 boys born for every 100 girls. The status of women in Asia has been third- or fourth-class for centuries. As these 14-year-old girls become 24-year-old women and realize they will be more valued in society, their status is going to change.

A thousand years ago in Europe, the same thing happened—there was a shortage of women. Men's families paid dowries because a woman was a valuable thing. The shortage of women in Asia is going to change a lot of things—politics, economics, education, and just about everything you can think of. For instance, it's going to do more for the unification of North and South Korea than anything else. Like everyone else, Koreans prefer to marry people of their own nationality. So in seeking Korean women, they may discover some from Queens, New York, or a few from Los Angeles, but they'll find the most Korean women in North Korea.

In Japan right now the women are really furious because it took only six months for Viagra to be legalized; it took over 20 years for the birth control pill to be legalized! I assure you, Japanese women are tired of being treated this way. One of the ways I have played this situation is that I have bought shares in birth control pills in South Korea and Japan. If you can figure out a way to invest in the evolution

of women's social standing throughout Asia, whether through a chain of beauty parlors or fashion or something else, you've got a chance to really strike it rich!

In terms of strategic investments, I would suggest working out a way to sell to China. The Chinese desperately need natural resources and if you can discover a way to sell something to China that they need and don't have, you may make a vast fortune. If I were an American in any multinational company trying to do business in China, I would research what they need. It's actually straightforward—they need copper; they need iron ore; they need a lot of things. Opportunities lie in selling China what it needs. You'll make a lot of money and avoid the pitfalls of government interference and regulation.

It's a winning proposition, but it's difficult to go into China and try to invest in a company without understanding the financials. In terms of selling insurance and financial services in China, keep in mind that they do want to make money and accumulate capital. It's a developing economy. They're going to have stock accounts and IRAs and 401(k)s and life insurance and all the products we have now. They're going to have them, but not by next week. If you can figure out how and when to sell them in, you'll be very, very rich. ●

Jim Rogers is the author of *The Adventure Capitalist: The Ultimate Road Trip* and *Investment Biker: Around the World With Jim Rogers;* and *Hot Commodities*. He is a visiting professor at Columbia University, a member of the Barron's Roundtable, and a knowledgeable expert for several television programs. Before he "retired," he was the co-founder of the Quantum Fund, which gained 4,200% while the S&P gained 47%. During both of the excursions chronicled in his books, Mr. Rogers talked to businessmen, bankers, investors, and local citizens to get a better sense of each country's infrastructure and investment opportunity.

Mr. Rogers has a B.A. from Yale University and a degree in philosophy, politics, and economics from Oxford University.

Knowing The Rules Of The Game

John Niepold, Emerging Markets Management LLC | Jan. 19, 2006

Our firm, Emerging Markets Management, was founded by Antoine van Agtmael, who came up with the term emerging markets quite a long time ago. Unlike a lot of other firms that focus on countries that are in indices and or are more high profile, we focus on inefficient markets in odd places. That's part of why emerging markets became an asset class in the first place. Some managers have forgotten that.

A few rules justify investing in frontier markets. Some of these may seem perfectly acceptable; others may seem a bit unusual for most investors.

First, in a lot of cases, small markets mean inefficient markets. As always, it is essential to visit companies, knock on their doors, and kick the tires. Investors should like inefficiency because they can do their own thing without much competition. If there aren't many brokers, there isn't much research, things don't trade very well, and there isn't much information, most institutional investors won't go there.

Second, often you can find very good companies in very bad places. While it may not seem to make much sense to consider going to Palestine or Nigeria to talk to a company, there actually may be a good number of very good investments to be found. It's a matter of keeping an open mind.

Third, a lack of liquidity isn't necessarily a bad thing. Liquidity would make our job easier, but it doesn't necessarily make things better. Illiquidity often means that companies are cheap. We don't shy away from a company just because it's illiquid. Often once a company is no longer cheap, it magically becomes liquid. So, sometimes there are opportunities in companies that are illiquid.

Before I joined Emerging Markets Management (EMM), I was in Indonesia. We had to do a lot of investigative work into family and political connections. In fact, we created a book that tracked how business groups were linked to Suharto and his kids. It was a very important part of making any kind of investment in Indonesia, or any emerging market at the time. Africa is somewhat different. A lot of nepotism goes on, but generally not in public companies, which tend to be very boring subsidiaries of multinationals. As I like to say, "They make more, but you pay less."

> The theory was that by exploiting inefficiencies we could find cheap, undiscovered companies.

For instance: SAB Miller. Where do they make the most money? Where do they have the best margins? It's not here in the U.S. where they sell you Miller Lite. It's not in China where they almost lose money. It's in places like Zambia where the country is too small to have more than one brewer. They have a monopoly. They have economies of scale. They're very good managers of their business. Their margins are very high, and growth is much higher; but you pay a multiple that's a lot lower.

Another example is Barclays in Botswana. Their nonperforming loan book is about 1% because they don't have to lend to anybody who's risky. In Botswana, there are subsidiaries of Coca-Cola, Unilever, and other global players. They all bank at Barclays, and they don't default on their loans. So we can find banks and other financial institutions that have incredibly high margins, but almost no nonperforming loans.

Twelve years ago a number of markets in Africa were opening to foreigners when EMM began to invest there.

The theory was that by exploiting inefficiencies we could find cheap, undiscovered companies. We also thought that portfolio theory might work. When you're in school they tell you that unrelated investments make nice portfolios.

African countries have little to do with one another. What goes on in Botswana has absolutely nothing to do with Mauritius or Nigeria or Morocco or Egypt. We believed if we invested in inherently very risky places, we might be able to find some diamonds in the rough and over time, may end up with a very nice portfolio with a good risk-return profile.

The nice thing about Africa is that countries don't really have that much to do with each other.

From small beginnings in frontier Africa, assets have grown substantially and we now invest in roughly 12 African markets outside South Africa. We thought the same frontier concept would work in the Middle East and we are now in small markets like Qatar, Palestine, Lebanon, Jordan, Dubai, and Bahrain.

What we've found is that the inefficiencies have borne fruit; our African Strategy has performed well with substantially less volatility than in emerging markets as a whole. The lack of correlation has actually produced—portfolio theory has worked its little magic. Individual markets have been extremely volatile, particularly in dollar terms, but the overall Strategy has produced a higher return with less risk over the longer term.

In Africa, countries don't have much money, and neither do investors. There have been some structural changes. In the early 1990s, the IMF was initiating structural adjustment programs that forced countries to privatize and open their economies. More recently, there have been a lot of pension reforms. In a number of countries, like Nigeria, there were no pension laws. As of Jan. 1, 2006, every company in Nigeria has to have a pension. And instead of structural adjustment programs, we now have debt relief. A number of countries that were the most indebted in the world, including Ghana, Zambia, and Nigeria, will have almost no debt as of this year. These events on the macro side will eventually trickle down.

Zambian debt is a good risk because they now have virtually no debt. The risk in Zambia is that over the last three months the currency has appreciated by about 25%. The locally denominated debt was very attractive, but now it's appreciated in dollar terms, currency-wise, by about 25%. There will probably be a limited supply. Someone who trades a lot of debt said recently that suddenly all the hedge funds want African debt. They're chasing yield like crazy.

The nice thing about Africa is that countries don't really have that much to do with each other. As a rule of thumb, 10% and 20% of the countries in Africa are in turmoil at any one point in time for any number of reasons. The names switch around. Some places, like Zimbabwe, that not long ago were the stars of the continent are now in turmoil. Investors should avoid those places when times look bad, although sometimes you can actually do very well.

A good case in point is the Ivory Coast. It is embroiled in a civil war right now. But it is a country whose currency is linked to the French franc and is now linked to the euro and thus guaranteed by the Central Bank in Europe. So the whole political problem did not play itself out in the currency, which is what normally would have happened. It was possible to make money over the next year from when the war started, because the stock market was seen as a safe haven for people locally who couldn't take their money out of the country.

Volatility in Zimbabwe has created opportunity. It's a wild, moving target. The market goes up 20% a day sometimes, and the currency drops by 15%, but net you're okay. If you want to get out, you've got to sell the stock, buy Old Mutual (which is listed in Zimbabwe), transfer the shares to South Africa, and sell them there. So there are ways to operate with lower risk than might be expected.

The Middle East is a completely different story. In contrast to Africa, obviously there's a lot of money in the Middle East. By our estimates, budget surpluses in the Gulf last year totaled about $150 billion. After Sept. 11, their assets were repatriated back to the Gulf States; that money is not floating around the world like it used to during big oil booms. It's floating around the Middle East, in markets, in crazy real estate projects and in almost anything you can imagine. The stories about all the cranes going up in Shanghai and Beijing pale in comparison to what's going on in Dubai. An unbelievable explosion in real estate projects are starting there. There's more money invested in Dubai than I've ever seen in such a small area. Also, in all my years looking at emerging markets, I've never seen more inefficiency, because in general—although not true of everyone—there are some very unsophisticated investors working there.

As a result of the investment boom, the Middle East markets look very expensive. Forward P/E is in the range of 25 or something like that. If you want to buy a bank in Saudi Arabia, you'll pay 10 times book. We have found some very good banks that are trading at 0.5 times book. What's out of favor is really out of favor, and what's in vogue is really in vogue. If you want to capitalize on those kinds of inefficiencies, the Middle East is a very interesting place to be.

Palestine has a stock market but they don't have a currency. Banks can be incredibly cheap there. Some hardly lend and have very low levels of nonperforming loans. They just take people's money, don't pay them any interest, and they earn interest on the money they get. And it's all in hard currency because they don't have a currency.

So there are a few such gems to be unearthed. Sure, you wouldn't want to bet the farm in Palestine, but Palestine was the best performing market in 2005. It was up 300% in dollars. And that's not even an emerging market. It's not on anyone's radar screen whatsoever, but what went up? Paltel, the cellular phone company in Palestine. What happens in times of turmoil? People want to use the telephone! ●

John Niepold is responsible for Africa and Middle East investments at Emerging Markets Management LLC. (EMM). He and his team currently invest in about 20 frontier markets in Africa and the Middle East. Mr. Niepold has managed The Africa Emerging Markets Fund and The Emerging Markets Middle East Fund since their inception.

Prior to joining EMM, Mr. Niepold specialized in emerging stock market investments as an independent consultant to institutional investment advisors, stock brokerage firms, and development agencies. From 1989 through 1991, Mr. Niepold was a senior investment analyst in Hong Kong, Singapore, and Indonesia for Crosby Securities. As a consultant, analyst, and portfolio manager, Mr. Niepold has visited and analyzed public companies in roughly 40 countries in Africa, Asia, Europe, Latin America, and the Middle East.

Mr. Niepold earned a B.A. in economics from Davidson College in 1984 and an MBA from the University of North Carolina at Chapel Hill in 1988.

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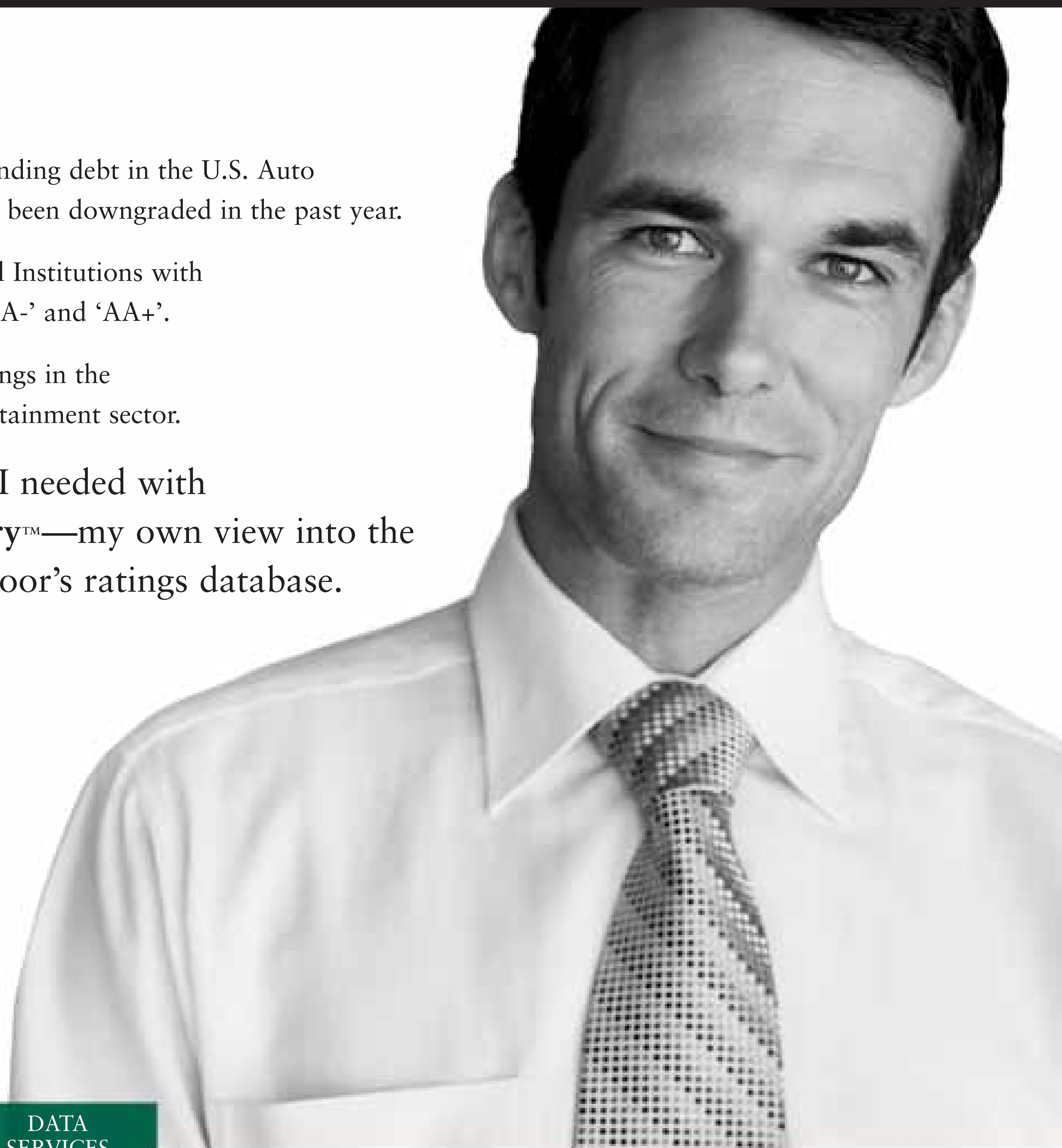

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Look For Gloom And Despair And Then Do The Math

John Bennett, Global Asset Management | Nov. 18, 2004

I see investing as an equation whose numerator is cash flow and whose denominator is the invested capital of the business. In other words, I'm looking for cash flow return on invested capital. Equity investing is never a business about absolutes. It's a business about shades of gray and inflection points.

Our world is somewhat dangerously growth-obsessed. If the U.S. model allows GDP growth of 4%, the European model must be bad because at best it does 2.5%. However, one should not necessarily follow from the other. We live in a world where it's very hard and getting harder for companies to expand cash-flow numerators, because expanding our margins typically does it. We live in a world where there is constant downward pressure on pricing and on inflation, and therefore on margins. It becomes harder to expand those margins and expand that numerator without high global nominal growth. You can make a lot of money by looking for shrinkage of the denominator. A key guiding light has been to look for those inflection points in businesses and whole sectors where they have been past destroyers of capital by having a bloated denominator, by having too much capital employed.

Europe is now at an inflection point, with companies and sectors waking up to past wasteful deployment of resources. For example, the post-World War II German economic model, like the Japanese model, has failed. In my view, the Germans have realized this—even its politicians. Led by the most unlikely country, Germany, Europe is beginning to change. Not because it wants to, but because it has to. Europe is at this inflection point because of a convergence of forces compelling people who don't want to change into change. There are now liberating capital markets. They are now starting to liberate product markets. Europe cannot stand in the way of pricing transparency in a world where Adam Smith's invisible hand is at work through globalization and the Internet.

The European Union accession is an important agent of change. An article in *The Economist* put it, "In an EU of 25 and rising, the French have finally woken up to the fact that they and the Germans no longer run the show." It is doubtful, for example, that the newly acceded countries will agree to the disastrous German and French tax and labor policies.

There will be no change in Europe until there is a sense of crisis. Europeans don't do things the American way. That doesn't mean to say that we're all wrong and America is all right, or America is all wrong and we're all right. They both remain very different, but now, finally, Europe is experiencing a sense of crisis. Europe is now having its version of riots in the streets, and we probably want to see more. Some people say: buy on the sound of gunfire. I think we buy Europe on the sight and sound of riots in the streets. Germany is crucial in this. Where Germany leads, France and the rest of Europe will follow. This has happened historically and it will happen again.

Something of a landmark deal happened on the June 24, 2004. Siemens belatedly said it was not very cost-efficient to make mobile phones in Germany. It wanted to fire 7,000 people and move the jobs to Hungary. IG Metall, the large German engineering and electrical union that has held Germany to ransom for decades, said, "No way." They then sat at the negotiating table, and the result was the jobs did not move. Not only did they not move, but IG Metall also moved from a ludicrous 35-hour workweek to a 40-hour workweek for no extra pay: an implied cut in wages of about 30% for those plants. Changes like this will not happen because of the politicians, but plant by plant. A Robert Bosch plant in France has also contradicted the 35-hour workweek law, and more changes are coming, at a seemingly glacial pace, but it is nevertheless happening.

Another recent example is that of Rolf Breuer, chief executive of Deutsche Bank, who has been threatening to move

bank headquarters to London to set up a holding structure. He's essentially telling Chancellor Gerhard Schroeder to cut taxes. Can you imagine a national champion such as Deutsche moving its headquarters? It could happen.

Also, many see the recent Volkswagen labor agreement as a defeat. Volkswagen wanted to get rid of 10,000 employees in Germany and move them to neighboring Poland, where wages are a fraction of Germany's, but they have agreed to extend the working week, a *de facto* labor cut. Examples like these abound.

Some examples of how rigid Europe has become include the long-standing, mandatory Christmas bonus, whether it was deserved or not. European employees historically have also received a 13th month of pay, regardless of the fact that everywhere else in the world there seem to be only 12 working months in the year. In Germany, they are only now introducing bonus schemes linked to profitability targets, something that's been unheard of here even 10 years ago. In Germany, there is a mandatory five-minute break for every working hour. These labor rigidities are ridiculous, but they are finally, if slowly, changing.

None of this would matter if we had assets in those countries that were overvalued. We don't these days. If you go to Europe, please visit Germany and witness the misery of people there. They have lost faith in their own equity market, which is trading at half its peak. Germany is exceedingly depressed about equities. Any private banker in Europe will say that their clients want yield, property-backed, private equity, but they don't want equities. As someone who likes valuation anomalies and is somewhat contrarian, I get excited about the misery I'm seeing in Europe regarding how they see their stock markets.

Despite this doom and gloom, I see this inflection point being rounded at several organizations, most notably at German banks. The chief executive of Commerzbank was recently lamenting in my office, "I'm trading at 85% of book value; I can't make any money lending to German national champions because we can't make an interest margin on them. I can't make money lending to Siemens at no spread. This must stop. How do I stop wasteful capital deployment?" German chief executives never used to come to see us, but now they are actively seeking ways to cut off heavy subsidies to German banks and return to a profitable model.

I absolutely agree that, in terms of diversification, in a 500-stock basis there's too little technology and so you're comparing apples and oranges when you look at one broad market against another. I think one is deluding oneself to think that European stock markets have a life of their own. The correlation between the DAX and the U.S. market has risen to about 90 in the past 12 months, and in times of crisis, it only goes higher.

The diversification you would get is currency, and that's people's decision to take. In terms of absolute value, I always ask myself, "Am I able to construct a portfolio of stocks that I believe is of reasonable value?" Right now, one can easily construct a portfolio of European stocks on 12 times earnings and 4% to 5% dividend yields. I don't think that's expensive.

People say demographics is destiny. The resale values of private equity properties will be seriously impacted in a 10-year time frame. Everybody, including the market, knows about the demographic problem; it's not a new problem. If our job is to be on the right side of surprise, it's not a surprise.

Many U.S. managers have succumbed to this thinking that Europe is open-air museum. Everybody's aging, everybody's dying. It's dangerous to think that things do not change. Can we imagine old Europe harnessing cheap labor on its eastern borders? I can. I always see my job as trying to look where there's gloom and despair. Clever capitalists are seeing something. People who were paying for distressed debt at 33 cents on the Euro two years ago, and that's now 65 cents on the Euro saw something. It's very dangerous to say it's all over for Germany. My instinct is always to say, "Well, can it change." Germany's government will likely get smaller. The French savings ratio went from 17% to 40.5%; there is some cushion there to start changing things. Politician and taxation change will be led by corporate change. ●

John Bennett is the investment director responsible for European markets. Mr. Bennett heads a team of four European equity specialists, running long only as well as long/short strategies. He has more than 16 years of experience in managing European equity funds.

Prior to joining GAM in 1993, he was a senior fund manager at Ivory & Sime responsible for Continental European equity portfolios. Mr. Bennett qualified in 1986 as a member of the Chartered Institute of Bankers in Scotland.

Pockets Of Opportunity Sprout In A Diverse Continent

James Kester, Allianz Group | Nov. 18, 2004

Allianz's investing in private equity dates back to the mid-1990s, when we set up a business of investing in third-party private equity managed funds to balance a direct private equity activity based in Munich. It was focused on mainstream German corporations. That emanated from very long historical equity ownership in a variety of German industry and finance. Mark-to-market, those returns would not have been impressive over a long period of time. However, significant equity value had appreciated in those companies.

Allianz realized it was an old way of investing privately and in private equity, and subsequently made efforts to divest those businesses and redeploy that capital in private equity. We currently have active portfolios in third-party managed funds of about $2.5 billion in the hands of 50 core managers located globally, although split 50-50 between the United States and Europe, with a small slice for other geographies. Within Europe, we are about 50% invested in larger buyout situations, 35% in mid-market buyout situations, and about 15% in venture capital.

Private equity in Europe is a large and growing market. For the first time in history, total transaction value in Europe over the past three years has surpassed that in the U.S. From 2001 to 2003, more than $200 billion in transactions occurred in Europe, as opposed to about $100 billion in the U.S. Some of that is a trough in U.S. activity. Through November 2004, it's about neck-and-neck. Announced deals are a little higher in the U.S. than Europe. But significantly, in Europe, the average transaction value has almost doubled: the large deals are getting larger, but it remains questionable if this is sustainable going forward.

In the last two years, Tyco, Siemens, and the other large acquirers of the world have been net sellers of businesses as opposed to net acquirers in the time prior to that. Going forward, can they continue to grow their businesses without acquiring new businesses? In private equity, European buyout returns have outstripped U.S. buyout returns going back to the European inception of record keeping in 1980. For European buyouts since 1980, internal rate of return numbers are, astoundingly, in the neighborhood of 30%. On the other hand, in venture, the tables are reversed. U.S. venture numbers have historically been very robust, around 25% returns for early stage venture, while European returns are roughly half that.

Private equity in Europe is a large and growing market.

Europe is not a unified market, at least in private equity. The U.K. market is the closest analogy to the U.S. market. The penetration rates of private equity as a percent of market cap are fairly close. There's a venture-to-buyout market and there's a vibrant mid-market that's also very competitive. Germany historically has been a large transaction or corporate restructuring market. The Mittelstand, the small and medium enterprises that are the backbone of the German economy, have not yet been willing to sell their businesses. After the 2001 corporate tax changes, it was expected that a number of properties would come onto the market but it never happened. Without any impetus, one cannot expect much activity going forward.

In the demographics realm, the implications for potential growth, given the aging population, are pretty dire. In 2003, Italy achieved the same demographic profile as Florida. In 2006, Germany is slated to achieve that same demographic profile. Germany's attempts to address the reforms of the entitlement state have not taken effect. The cultural and entitlement shifts needed to make these economies more flexible and growth-oriented will take longer to happen.

Italy is another market anchored by strong family-owned businesses, although there appears to be more liquidity there

than in other geographies. France is an interesting case; it's actually a vibrant private equity market. After the British, they are the most accepting of the notion of private equity. However, French mid-market managers believe private equity can be an enriching way to transfer from being a manager to being an owner of a business. The resulting activity, both in the mid-cap and large-cap space, is pretty lively, even to the point where I'd be cautious about that market in the future. There's a very high level of secondary buyout activity, with one sponsor selling to another sponsor, which can be viewed as a sign of a lack of viable exit alternatives and an oversupply of capital.

In private equity, I'd hesitate in investing at the macro. Poland, the Czech Republic, and Hungary are clearly more growth-oriented engines at a macro level than Germany. It's easy to draw analogies to Spain. Spain hasn't been a great private equity market in the last decade. There have been good deals, but few Spanish private equity managers have shown consistent alpha. I would be cautious about Eastern European private equity. The underlying factors are good, but there is still a lack of good managers. You need a generation of quality managers who can take companies, often in growth-oriented situations, to compete with multinationals from point A to point B.

There are pockets of very good technology and innovation all over the continent, and there's a developing entrepreneurial culture.

There are several considerations for investing in European private equity. First, to quote W.C. Fields, "Sounds great; count me out." I'd give you the inverse advice. Rather than invest in the U.S. venture market, where a huge amount of capital continues to flow, you should scout out the pockets of opportunity that exist in Europe. The U.S. returns have been the saving grace of global institutional investors, with more than $20 billion in average fund raising into the U.S. venture capital market. Many practitioners would suggest that number is unsustainable. There will always be great returns for several firms, but on the whole too much capital is driving into the U.S. The reverse is true in Europe, where historical returns have been terrible and capital has vanished. Yet there are pockets of very good technology and innovation all over the continent, and there's a developing entrepreneurial culture. For example, we're seeing stunning things happening in technology in Ireland. Great developments in life science are taking place in Cambridge, England, and some other places on the continent. Of course, you will have to do the work to understand the investment opportunity, but the potential is there.

Second, most multi-generational family businesses in Europe are likely to stay family-held businesses for another generation or two. Nevertheless, several businesses that started post-war are seeing generational transitions. Those are more likely to trade hands than the long-held family-owned businesses.

Third, each market is different. You need to know what you're getting into in the various markets. For example, Germany is a corporate restructuring market, a vibrant market for large-cap spinouts and carve-outs coming from large corporations like Siemens and Roche. But there's also a small-cap market in corporate restructurings. You would not want to be investing in growth in Germany anytime in the near future. Spain, along with Ireland, is the vibrant engine of growth in old Europe. There are opportunities to invest in growing businesses and business models in Spain, and it is developing a strong private equity fund manager environment. Many large cap players are addressing corporate restructuring opportunities in Germany and other markets, which are based in London and yet employ a pan-European business model. But it's very difficult to pull off. Divided they fall. The economics need to be properly allocated, and communication needs to be very well developed. Tread lightly in that space.

Fourth, the Yanks are coming. Bain Capital, KKR, and the like are raising capital, raising stand-alone funds or investing more of their global funds in Europe. This trend has both positive and cautionary elements. On the positive side, the U.S. private equity market and managers are more highly evolved. They understand resourcing models better. They understand how to operate their organizations better. They often have deeper sectoral expertise. On the cautionary side, many have ignored the local cultural dimension. They've gone in with U.S.-based, not local people and ended up buying the wrong asset or not being able to buy assets.

Fifth, bigger deals are happening. They're happening on both sides of the pond. Such capital deployments are a driver of what's happening in the private equity world these days. Tread lightly here as well. Fund pools of capital are not properly sized for the environment of the last two years, but are based on the last five years of what the general partner had been able to execute.

Here is a list of diligence rules:

1. There is no substitute for proper due diligence. The third-party managed fund space is huge. There are thousands of managers globally. You have to make sure you are investing with the best if you want to keep those returns.
2. Throw the PPM out the window. Marking to markets is potentially illusory if you are marking to markets trading

at forward premiums. You want to bank on realized returns, and you won't always see a clean track record of realized returns creating alpha.

3. Follow the money. General partners' sponsors know how to maximize their net returns. Their net returns don't just come from the investment gains of their funds, but also from the fee side of their business—both the management fee you're paying as well as the transaction fees they take from your assets that they're buying with your capital. Hold their fees to the fire; understand what they're making on a current basis to keep your interests aligned.
4. Know thyself and know thy neighbor. If you don't have the resources to do the diligence work yourself, either don't invest or outsource it to somebody who does. You are about to get married to a general partner for 10 to 15 years, and you will be asked to make a commitment in as short as three or four weeks. *Caveat emptor.* ●

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Prior to joining ZAAM, Mr. Kester was co-CEO of Allianz Private Equity Partners GmbH (APEP) from 2000 to 2006, as well as chairman of Allianz Private Equity Partners, Inc. (U.S. subsidiary). He was a member of the Investment Committee. APEP is a global private equity fund-of-funds manger with about. $4.5 billion of assets under management with 40 employees in two offices.

Mr. Kester has 22 years of experience in private equity, business development, mergers & acquisitions and corporate finance for such firms as Aurora Ventures, Barents Group, General Motors, and General Electric. He holds a B.S. degree from Cornell University and a MBA from the Wharton School at the University of Pennsylvania.

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Slow And Steady Can Win The Race

Samir Arora, Helios Strategic Fund | July 21, 2005

I have been following Indian markets since 1993, and often during this time I felt that one day India would be the largest emerging market in the world primarily because all the other markets would have become developed by then. It's only in recent years that we can, on a top-down basis, somewhat justify India.

During the early part of my work for Alliance Capital in India, the debate was always between a top-down and a bottom-up view of India. And our view used to be bearish and over-weight. We were bearish on a top-down basis. We were not comfortable or happy with the progress of liberalization or what the government could or should have done and were bearish. We were, however, over-weighted because there were still some good companies we could believe in.

The cumulative reforms of the last 13 or 14 years provide new investors with a sense that there are new opportunities to be found. It may have taken 14 years for what could have been done in five, seven, or 10 years, but today in many industries, the opening of the industries, the reforms, and the various steps that have been taken—starting with how much can foreigners own, how much should domestic investors own—have all been slowly clarified. The entry norms for investment are now established. The reforms have finally happened, although they proceeded very slowly for people who endured and participated in that process.

India one day should figure in Malcolm Gladwell's book, "The Tipping Point: How Little Things Can Make a Big Difference," because a number of small things have been done that have pushed India beyond the tipping point without any one big thing having been done. Perhaps this is why many people are still not satisfied with conditions for investment in India. But we and several others are satisfied because doing it slowly has meant that we have been able to participate in the movement of this reform and the progress of opening up this market.

One major predicament with India is that on a top-down basis you can build any story you like—bearish or bullish. In the past few years, India has gained stature and confidence because of the success of her IT sector and the fact that India has an inexhaustible pool of talented or educated English-speaking graduates. However, India also has 350 million illiterate adults who cannot sign their names, which is the definition of illiteracy in India.

In one sense you can say that India has 25% of its people living below the poverty line and on the other hand that Indians own more than 10% of the world's gold reserves—a $200 billion value in today's market. And if people believe that gold is going to be going up, then India will be the biggest beneficiary.

India is demographically an attractive market because of the higher pool of people in the working age *vis-à-vis* the retired age. In the next five years, supposedly, 80 million people will be added to the 16-64 age group in comparison to zero in Europe, minus three million in Japan, and about 20 million in the U.S. But the question is will we be able to generate 80 million jobs for that young pool of people joining the workforce because over the past 10 years in India the employment generation track record has not been very good.

From a top-down basis, it will always be dependent on your perspective and on what to focus on. However, India's real story is bottom-up. It is a story that basically in many industries and in many sectors, transformation has happened and is happening, and it is easy to understand, easy to see, and easy to make money.

Looking at the progress of the bottom-up story, we see that from 1991 onwards liberalization started, affecting different industries in different sectors. But even before 1991 there was a stock market in India. It was established in 1875 and there were many listed companies at that time—5,000 or 6,000 companies, or more. These companies were operating in the private sector arena where the role of the government was basically that of an irritant. The government's role was to impede expansion, inhibit foreign technology, govern the process of hiring and firing, block a merger, or approve or

not approve a license if a company wanted to expand capacity. But otherwise, these companies were all competing to the best of their ability in those sectors in 1991 and before.

When liberalization happened, it meant freedom to operate, freedom to restructure costs, freedom to price items like cement and steel or pharmaceuticals at market prices. The liberalization process took the next 10 years for companies to grow. But from an overall market point of view, nobody would have made money in these sectors if you had invested in all the companies. In 10 years some companies emerged successful, like Bajaj Auto, but there were many companies that went bankrupt because they:

- Could not handle the reduction in protection;
- Could not handle the fact that their competitor had grown bigger; and
- Could not handle the fact that newer companies from abroad came in or newer companies were created to take advantage of this liberalization.

The biggest mantra for us in terms of investing in India is to compete with the government of India.

All in all, we have an efficient group of companies in those sectors today, but you had to find a few companies in 1991-1993—the ones who ultimately were able to succeed, but it was not necessarily clear who would be successful. Bajaj Auto, for example, which turned out to be a very good investment, was at the top of my personal hate list because of what the company management used to say in 1994 and 1995 regarding liberalization.

Another group of companies and sectors were previously all government-controlled sectors like banking, telecom, insurance, asset managers, ports, airlines, and infrastructure. The optimal model to privatize these companies would have been that the government of India takes its existing company, which is already in business and strategically sells it to someone, giving them one or two years of further monopoly for them to sort of restructure this company in the way they want it, and then open the sector to the world. Therefore you have achieved privatization.

Now, because of politics, India was never able to strategically sell—other than I think in one case—a company to anybody. So what we get in India in the public sector companies is basically divestment of shares into the market. That means you can buy shares of that company when the government wants to raise money, but there is no change in the management incentives, wages, salaries etc. Basically, the government controlled what remains, and these companies become technically private to the extent of only 20% or 50% but not completely.

India opened all its sectors to private companies instead. This gives enormous opportunities for the private sector companies that enter these new sectors of telecom, banking, insurance, and asset management and many other sectors basically came in without paying any premium because the sector was opened up to anybody. So the new companies come in, pay no premium and—over time—kill the government company. That is what has been done in sector after sector and more or less in every sector, investors have made 50 times and 100 times. But broadly you could make 10 or 20 times without any real effort because the whole group of new companies that came in ended up cumulatively owning 60% to 80% of that industry, reducing the original government entity to a minority.

From an overall point of view, this whole process has happened very slowly. Top/down investors or top/down strategists will say why has India done this slowly? That has been the best thing from a stock market point of view because not all sectors were opened together. This transition of share from government to private equity has not already happened in all sectors. There are many sectors where the government owns 80 or 90% of that industry in terms of output and we feel that is a huge opportunity. It will go on for at least another 10 years because many sectors have been opened up in the last three or five years and not all were opened in 1990s. So the biggest mantra for us in terms of investing in India is to compete with the government of India.

This is completely different from the Chinese model. That is why I think no one makes money in China because in China you basically buy that company, which is the government company, and only own a 2% or 5% stake. The Chinese delay the opening up of the market until they are able to fully realize the value of their government-owned company. And that is why you are not able to make money in China.

Another reason why you are able to make money in India is because of foreign restriction. It is very good that insurance companies and telecom companies and power companies do not get 100% foreign ownership because we want to participate in these sectors via the stock market. If it was all 100% foreign owned, then somebody will make money but it will not be us—and we are talking about Indian equity investors here!

In terms of risks, the biggest risk in India is that you don't know the next risk. In 1994, we had a plague. In 1995, when Manmohan Singh was the finance minister, he raised interest rates by about 500 to 600 basis points causing the market to fall 35% in one year. From 1996 to 1998 there were three governments and one government lasted only 14 days. In 1998, India detonated a nuclear bomb and U.S. sanctions on

India followed. In 1999, we had a war with Pakistan and Cargil, and in 2000, a normal worldwide correction. In 2001, there was a stock market scandal. Between 2002 and 2003, India experienced its worst draught since independence. So these were all the risks that we could not have imagined before. But broadly, the risks in India are quite a few, but the opportunities I think outweigh that.

India has many banks in general. India has about 20 or more public sector banks. It has about 10 to 15 private sector banks, and nearly all foreign banks. The problem has been for the foreign banks—they have not been allowed to increase branches beyond around 12 to 15 per year. But beyond 2009, I believe all foreign banks will be allowed to act in India as similar to local banks. But in general the banking sector is all developed and growing at a fast pace. One of the biggest companies in India is HDFC, which is in the personal mortgage market and it is owned by more than 70% by foreign investors.

We have many private banks—Indian-owned private banks, where foreign ownership is not allowed. Foreign banks are allowed top own 5% in any Indian bank today, and in 2009, all these restrictions will be removed. So the broad map for banking is that it will be opened in 2009. We like the private sector banks. But in India, the story is known and there are many mortgage products out there already. ●

Samir Arora is the founder and fund manager for the Helios Strategic Fund. From 1998 to 2003, he was the head of Asian Emerging Markets at Alliance Capital in Singapore, a position from which he resigned in August 2003 to focus exclusively on India. He was also the chief investment officer of Alliance Capital's Indian mutual fund business and, along with managing Asian emerging markets mandates, managed all its India-dedicated equity funds.

In 1993, Mr. Arora relocated to Mumbai from New York as Alliance's first employee in India to help start its Indian mutual fund business. From its inception in 1995, Mr. Arora served as the chief investment officer-Equities of Alliance Capital Asset Management (India). He also managed ACM India Liberalization Fund an India-dedicated offshore fund from its inception in 1993 until August 2003.

Prior to 1993, Mr. Arora worked with Alliance Capital in New York as a research analyst. India-dedicated funds managed by Mr. Arora received over 15 awards during his tenure including the highly coveted 'AAA' rating from Standard & Poor's Micropal for four years in a row (1999-2003) for the India Liberalization Fund. In 2002, Mr. Arora was voted the most astute equity investor in Singapore (Rank: 1st) in a poll conducted by *The Asset Magazine.*

Mr. Arora received his undergraduate degree in engineering from the Indian Institute of Technology, New Delhi in 1983 and his MBA (Gold Medalist) from the Indian Institute of Management, Calcutta in 1985. He also received a Master's degree in Finance from the Wharton School of the University of Pennsylvania in 1991 and was a recipient of the Dean's Scholarship for distinguished merit while at Wharton.

Demographics Favor India's Emergence In The Long Run

Ashish Dhawan, ChrysCapital | July 21, 2005

There has been a clear acceleration of growth over the past 100 years in India's economic life. India grew at 1% between 1900 and 1950; at 3.5% between 1950 and 1980; and then 6% between 1980 and 2004. In the past two years the economy has grown at an average of about 7.5%.

More importantly, net population growth has consistently come down. When you compute GDP per capita, the rate in the era when India was growing at 3.5%, the figure was actually 1% because net population growth was 2.5%. At 1%, you double GDP per capita every 54 years. Today, growth in GDP is 7.5%, but net population growth is closer to 1.5% therefore GDP per capita growth is at 6%. Comparatively, GDP per capita doubles every 12 years at current rates as opposed to every 54 years with the 1950-1980 growth rate.

While a number of changes at the macroeconomic level started in 1991, it often takes a decade for changes at the macro level to filter down into the micro economy. To give a picture of India over that decade and a sense of how that change took place, I will point out one individual and one company, in particular. The individual is Rahul Bajaj and he runs Bajaj Auto, which was once the largest, now second largest, manufacturer of two-wheel vehicles in India.

When India flung its doors open in 1991, the reaction of the industrialists, and in particular Mr. Bajaj, was to form the so-called Bombay Club. The Bombay Club was a group of industrialists who basically wanted to protect their vested interests. Their goal was to convince the government to maintain tariff barriers and prevent foreign investments from coming in because they were worried that their companies would get washed away. Between 1991 and 1996, it was effective in preventing reform.

Eventually businessmen realized, including Mr. Bajaj, that the world had changed. Globalization had set in, India was part of the world, and we could not be isolated from the world. So then we had the next phase from the mid-1990s through the late 1990s when Indian businesses hunkered down and became more efficient because they realized that the government was giving them time by phasing in reforms. Trade barriers weren't coming down immediately—we didn't have shock therapy the way Eastern Europe did—and so they had five or six years to change.

During that period, Mr. Bajaj doubled production but cut its workforce in half. Productivity of the workforce went up four times over a period of six or seven years. Today, Mr. Bajaj is a proponent of India integrating into the rest of the world. Over that 10-year period of time, as Indian businesses have become competitive, there's been a sea of change in entrepreneurial behavior in India.

As Indian businesses have become competitive, there's been a sea of change in entrepreneurial behavior in India.

There have been four changes, in particular, in the mindset of the entrepreneur. The first facet of change is different aspiration levels. When we went and visited companies six years ago, people were talking about taking a business from $100 million to maybe $150 million-$200 million. Now, people have learned how to dream big. I think they have been inspired by companies such as Infosys Technologies Ltd. and Wipro Technologies and a number of other Indian success stories that have out-performed expectations.

The second facet of change in the entrepreneurial mindset is global outlook. When I visit a company that generates $100 million of revenue in any industry, management can tell you what is going on in their industry in any part of the world. They are benchmarking themselves against European, American, and Chinese companies. There is a clear awareness of what is going

on around the world and the benchmark is no longer the company next door, but rather a global benchmark.

The third very important facet is that somewhere along the way I think people realized that corporate governance pays—that it pays to be honest in business. And the way I would describe it is that the entrepreneur figured out that 15 times earnings is better than one times stealing. It's much better to create wealth through market cap as opposed to dividend stripping and taking assets out of your company at the expense of minority shareholders.

As an investor, one of the advantages of India is that we have a fairly deep and broad market.

Companies like Infosys, HDFC Bank, and ICICI Bank have led the way in terms of inspiring younger companies in that direction. Much of this is irreversible because the changes at the macro level have now filtered down into the micro economy and behaviors have changed. Entrepreneurial behavior has changed. They don't want to go back to the old way. Consumer behavior has changed. Look at consumers and what they experienced 15 years ago. I grew up in India. I remember it used to take three months, often a year, to get a phone line. Today there are 10 telephone companies that offer you phone service. There were three car lines available as well, all of circa 1960 models being offered 20 years later. Now we can buy one of 50 different types of cars—represented by all manufacturers. Consumer choice is now available and I don't think the consumer ever wants to experience the era of scarcity when there were very few choices, if any.

As an investor, one of the advantages of India is that we have a fairly deep and broad market. India systematically does well in industries with high return on capital such as IT services because little capital is required in that labor-intensive business. If you strip out the cash, return on capital employed (ROCE) is close to 100% in the IT services. For example at Infosys and Wipro, ROCE is well above 50%. So while these businesses grow, they do not consume capital—they generate cash. The same is true of the business process in outsourcing, pharmaceuticals, and banking. These are great businesses for investors because you get growth and growth translates into return. While China does very well in mass manufacturing, the problem from an investor's standpoint is that margins are terrible, barriers to entry are low, and return on capital is poor. I believe there is a systematic bias in India toward being competitive in areas where return on capital is actually pretty good, and that works well for investors like ourselves.

The fourth facet is the private equity market. There has been a sea of change in the acceptance of private equity as an asset class in India, created in the early 1990s. We have seen an explosion in private equity off of a very small base, and it is still very small numbers today. This market was $500 million in terms of equity invested in 2002. In 2004, $1.3 billion was invested, and in 2005 between $1.75 billion to $2 billion will be invested by a variety of private equity players. The market has three segments:

- The high end, which is $50 million up to $200 million or $300 million;
- The mid-market, which is $10 million-$50 million in equity; and
- The venture market with about $3 million to $15 million dollar in equity.

We have a private equity market today in India that's fairly vibrant. Five years ago everybody was doing everything. Very few firms had a strategy or a focus. Now we have a large enough market where there are several players who can focus either on a set of industries or in a space, whether it is growth, capital, venture, or buyouts. The market has segmented. The players' capabilities have risen because they have started honing their skills in the area that they focus on. The new capital coming into India will largely impact the high end of the market—for example, the larger deals will get priced at higher levels. Valuations will be driven up because there are very few of them and several global players want to be in India and are forced to play in the large spaces because of their fund sizes.

There are risks. First, there is a very high fiscal deficit. India runs a fiscal deficit of about 9%-9.5% of GDP. Debt/GDP ratio is at 83%. It was at 58% five or six years ago. The reason the higher debt/GDP ratio has not been felt is because while it has been rising, interest costs have been declining. India has fairly long-dated borrowings and has continuously refinanced its paper at lower interest rates. So, in terms of absolute interest costs, it has not increased in line with absolute debt. I think that trend will persist for the next three-to-five years because India continues to refinance old paper and old government debt at lower rates, increasing debt/GDP. At some point, because the fiscal deficit problem has not been fixed, the debt/GDP ratio will hit 100%. If rates rise, then debt levels and interest costs will increase the debt burden.

India has been fortunate because the debt trap is not visible. Politicians will need to muster significant political will to push through change reducing fiscal deficit. The only mitigate to the fact that deficits are high and debt/GDP is spiraling upward is that it is all a local problem. Savings as a percent of GDP is 26%.

The second issue is valuation. If you look at valuations in India, they've gone up dramatically while the overall market

still trades at 15 times earnings. That is a composite, and that composite is composed of commodity stocks. Do commodity stocks deserve to day trade at 15 times peak earnings? Do cyclicals deserve to trade at 15 times near peak earnings? Do financials deserve to trade at 15 times earnings? These are the questions I ask myself. So while the overall market is not too overvalued, my sense is it is somewhat and you have to look at it sector-by-sector to see where the overvaluation is the highest.

The third and largest issue is exuberance. Investors are ignoring risks that exist in their companies. Small companies get the same multiples that large companies get today, whereas that gap was fairly wide four or five years ago. Bad entrepreneurs, individuals who defrauded banks and had not properly structured their companies, had been blacklisted four or five years ago by the capital markets and could not raise a dime of capital. Today, they are back in the market raising capital and their companies trade at valuations very similar to well-run companies.

Today, there is a lot of story-based investing occurring as excited investors come to India for the first time, run through a PowerPoint presentation, and are told a story. The investor goes away and throws capital into that company without a sense of what the company is all about, what the governance really looks like, and the risks involved. Some of those risks are being ignored in this environment, and that is a global phenomenon. There is a lot of exuberance in emerging markets in general. That does not mean that if you have a discerning eye you can not find companies that are well-run, have good governance, and create reasonable valuations. We believe you can, but one needs to be careful in this environment.

From a macro standpoint, another risk is India's poor infrastructure. India spends about $35 billion in infrastructure per year while China spends $260 billion per year. Some areas of infrastructure, such as telecom, have improved. Teledensity, the number of telephones per 100 people, has gone up five- or six-fold in the past six to seven years. Given the cellular explosion, I don not think we need to worry about the telephone sector—it will take care of itself since it is largely in private hands. There has been some improvement in India in other areas like ports. Facilities are modernized and container terminals are sold to foreign operators. As for roads, a national highway system is being built. While it may take a year or two longer, by the end of this decade India will have a fairly robust national highway system.

> The bigger issue is the infrastructure balance of power, which is where the whole center/state issue comes into focus.

The bigger issue is the infrastructure balance of power, which is where the whole center/state issue comes into focus. Unlike China, India can not cure urban problems by forcing people to move. For those of you who have visited Mumbai, I'm sure it is very visible that we have urban infrastructure issues.

Those are some of the major risks. As an investor, I worry less about the political risks because while India doesn't have the political will to push through bold changes; its politicians are not doing anything to reverse change. The fact that foreign investment is not fast enough is sometimes an advantage as an investor. The fact that foreign banks can not buy local banks right away means that an investor—and foreign investors as well—can get into these banks before the door opens up in 2009. I am also less worried about the political risk because even though the government is not fixing certain major problems, the economic agenda of the two political parties is fairly similar. The economic agenda of the Bharatiya Janata Party and the Indian National Congress is not that different. Since 1991, we have had several different prime ministers but not

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a lot has changed in terms of economic policy. The rate of change may have been faster in terms of bold steps under one regime versus the other, but there has been no reversal when there has been political change.

I am very bullish on macroeconomic growth of India over the next couple of decades. Demographics clearly work in India's favor and I think India has learned to handle demographics and the increased population to put them to work. In India, 54% of our population is under the age of 25. With 1.1 billion people, it has a labor force of 420 million people. India is going to go through a massive demographic change in the next 20 years because our net population growth has slowed down naturally. India's population will increase from 1.1 billion to about 1.5 billion in the next two decades, but labor force will rise from 420 million to approximately 750 million people.

The last point I want to leave you with is that I think the India story from an investor's standpoint is a 20- to 30-year story. You have to keep that in perspective. I think often people rush in and get too excited and want to make money very, very quickly. Particularly in this environment, where lots of areas are overheated and where the risks often get ignored, I would say investors ought to look at investing in India, but ought to be cautious as well. If you get washed out or if you get burned in the first two or three years, I can assure you that you're going to miss out on the 20-year story. You will essentially be jaded by the experience of the years when you did not make money. ●

A Remarkable Day And An Historic Turnaround In Relations

Frank Wisner, American International Group, Inc. | July 21, 2005

July 18, 2005, will go down as one of the defining moments in the relationship between two very important powers—the United States and India. The India that arrived in Washington, represented by Prime Minister Manmohan Singh and his entourage, held meetings with the President of the United States, the joint session of Congress, and the State Department. In a remarkably short period of time, the meetings brought out the different ways the United States and India have come to view each other through very different lenses.

The most striking feature is the remarkable growth of the Indian economy, an economy that today is achieving about 7% growth in GDP and shows every reasonable promise of an average of that for the years ahead. Within a setting of declining inflation, the numbers are down to about 5.5%.

As recently as the early 1990s there were only a couple of months of import coverage. Today, with $150 billion in the bank in reserves, the highest foreign exchange reserves in India's history, India has never been so comfortably situated. And the growth experienced in India today is broad-based. It is not just in the well-known service market that has great export potential, but Indian manufacturing has been enormously successful and competitive worldwide. Agriculture remains volatile, given the fact that the overwhelming majority is rain-fed. But the capital markets have perked up. Interest rates are lower. When I left India, they were in the middle-teens. Today, they are down to about 6%.

These figures represent a steady but occasionally uneven retreat of government from the commanding heights of the economy and the assertion of the Indian private sector. India is, in my judgment, on the road to an open economy. The growth that India is experiencing is driven principally by domestic consumption. This huge, untapped Indian market will continue in the years ahead to power Indian economic growth. A credit boom, rising incomes, a growing service sector, and positive demographics—now that India can care for her people, with 54% of the population under 25 and the highest levels of literacy in history—set the stage for India to become a market in which population is less a detriment than an attribute.

Capital expenditure by business and infrastructure spending by government are up and will continue to be so in the future. Underscoring the importance of the domestic market, foreign trade is a powerful sector of the Indian economy, expanding at about an average 20% per annum over recent years. But the primary reason that India's economy will grow is that is has ceased to be an economy that is dependent on the decisions of government, but rather it is an economy that is powered, fueled, and led by the Indian private sector.

At the moment, consolidation of the telecommunications market will be very big ticket items for American investors to assist in consolidation. There are also opportunities in consumer finance. AIG is putting together an asset management company and consumer finance companies. It is being done on a green feel basis as opposed to buyouts. I think these are markets, in general terms, which have growth potential. But be patient, take the time it takes to build a proper investment, and play for the long term.

Optimism aside, India can do much more, and in fact some aspects of its performance are worth attention. I'd like to think that India could have an 8% to 9% growth rate, but doubt that it will for many reasons. First of all the fiscal deficit in India is a big problem for the nation over the longer term. A rising public debt matched by deteriorating finances in the Indian states, in addition to off-budget finances, add up to a troubling fiscal picture—one that, given the politics of India, the government finds difficult to deal with.

Those who go to India for the first time will be struck by other aspects that drag India's performance: a very, very large public sector with a very large workforce, either in government or in state-run enterprises This is coupled with a

low tax take that provides less than the necessary level of government investment, particularly in infrastructure, electricity, transportation, and health and education. Also, they will be struck by the complexities of Indian governance—the complex known to us in this country of issues posed by center/state relations. In the electrical power sector, for example, Tamil Nadu and, until recently, Maharashtra limited the possibility for foreigners to invest in electricity for a growing India.

Labor laws are troubling, especially the difficulty of hiring and firing people. Also, notable for American businesses, it is complicated to get past some of the ownership cap issues. Indian official policy limits the ability of foreigners to own majority positions in insurance, banking, and to get into the media, retailing, and pension markets. Tax authorities are tough in India—occasionally whimsical, quite unpredictable, and dialogues between the tax man and a businessman are notably absent. India today remains a land of high tariffs, though levels have come down quite sharply over recent years among major Asian nations in the international market. India's tariff levels remain still quite high—in the mid-teens. They are expected to come down, but one would also like to see a dynamic Indian external trading policy that would greatly benefit India.

Another factor highlighted on July 18, Indian-American relations represent a remarkable turnaround in history. For most of the near 60 years of India's independence, the U.S. and India have been at odds with each other. Significant moves began with President William J. Clinton's meetings with Prime Minister P.V. Narasimha Rao of India. They accelerated but were temporarily checked by India's nuclear tests in 1998, but picked up most strongly by the President George W. Bush Administration and carried to their current level. What lies at the heart of the Indian-American change is a sense that both nations need the other if the balance of power in this complicated post-cold war world is to be maintained. In short, if peace and the conditions of prosperity are to be maintained, many important nations have to play their role. And India, with increasing self-confidence, is emerging in precisely that role.

If peace and the conditions of prosperity are to be maintained, many important nations have to play their role.

The joint statement by the president and Manmohan Singh testifies to the common perspectives of two nations bound by common values, a belief in democracy, common interests, their views of the world, and what would be good for our respective citizens. The joint statement goes on with a path-breaking set of decisions to accept, in essence, India's nuclear capability and endow the relationship with civil nuclear trade and the benefits of a collaborative arrangement. Where next?—normalization or detente between India and Pakistan, with the threat of deep-rooted conflicts returning. I also will keep a watchful eye on how India and the United States view China and manage that relationship. ●

Ambassador **Frank G. Wisner** is vice chairman, External Affairs, at American International Group. A career diplomat with the personal rank of career ambassador, he previously served as U.S. Ambassador to India from 1994-1997. Additionally, he held the positions of ambassador to Zambia (1979-1982), Egypt (1986-1991), and the Philippines (1991–1992).

Mr. Wisner has served in a number of positions in the U.S. government, including Undersecretary of Defense for Policy (1993-1994), Undersecretary of State for International Security Affairs (1992–1993), Senior Deputy Assistant Secretary for African Affairs (1982–1986), and Deputy Executive Secretary of the Department of State (1977). During the course of his career, Mr. Wisner served in the Middle East and South and East Asia.

He is a member of the Boards of Directors of the American Life Insurance Company, EOG Resources, Ethan Allen, and Office Tiger, as well as the boards of numerous nonprofit organizations. A native of New York, Ambassador Wisner was educated at Princeton University.

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An Economic Samba: Three Steps Forward And Then Two Steps Back

Peter Gruber, Globalvest Management Company, LP | May 19, 2005

I first visited Latin America in the early 1960s on a two-week trip. I was a little taken aback at the simplicity and the primitiveness of it. It seemed very far away from the U.S. economy in the context of the lives of the ordinary people. There existed an enormous class division based on education and the practice of class distinction was quite common. The development of Latin America has unfolded differently than in the United States. Brazil had a king until about 80 or 90 years ago. The U.S. became an independent country in 1776. I don't believe that people throughout the world are any different, but they govern sometimes with different kinds of traditions, backgrounds, and history that taint them and even educate them to behave not as individuals, but as a group.

The propensity to remain in a class-driven society has gradually changed in the region. The changes over the past 20 years have nothing to do with the political dimension. They have to do with the communications—the inability of the governments to control information flow. This is now happening globally. It is not only happening in Latin America, it is happening in China and in Russia. The breakdown of Russia was not based on a U.S. victory so much as over the fact that these people could turn on the radio.

Today, with the Internet, it is impossible for governments to control information flow. They have to appeal to the rationale of people and this affects investments. I believe that Latin America has changed enormously, not because of the politicians, but because of information. The access to information has become more readily available, less censorable by government. The middle class is now able to travel and see how things are being done elsewhere and how people are living. That information—that freedom—is expanding globally, mainly because of technology.

Latin America will become the beneficiary of this process. The individual will probably be able to contribute far more. The region is growing enormously. I have faith in people, and believe that eventually, if they allow a measure of freedom, the economy will grow in very much the same way as the U.S. has grown, but much faster because the availability of technological advances.

> There are basically seven major players in the world—the U.S., Europe, Russia, China, Japan, India, and Brazil.

Brazil today has a steel industry that it did not have 50 years ago. Today it is competitive and exporting its product. That development will continue. There are basically seven major players in the world—the U.S., Europe, Russia, China, Japan, India, and Brazil. The reason I see these countries as the seven major players is because they have the population base and they have a huge geographic area, providing that their governance becomes freer and uses its internal enterprising elements. Argentina will never have a steel industry the size of Brazil with its vast iron ore reserves, so it does not have a competitive advantage. Nor does Argentina or Chile have Brazil's 200 million consumers—therefore they will have to take advantage of their particular physical resources that they have in order to develop their specialties.

There are countries, however, that have developed their own particular specialties. Many countries in Europe have

developed industries similar to Germany and are now moving those industries to Eastern Europe. Latin America is advancing considerably in higher technology, and the result is that we end up with more and more technologically developed products that allow us to compete and increase the standard of living for most people. And that means essentially following the free market.

I have always been a great believer in the free market philosophy of letting the markets shape supply and demand. Latin America is going through this process right now. It has nothing to do with the political wish of the group. I think they are a little bit behind. They are not taking into the account the average person's desire for a better family life and a better standard of living. They truly have not yet adopted the notion of the free market.

The Latin entrepreneur is as enterprising as an American or European entrepreneur.

The British foreign office used to have an old adage: "We have no permanent friends and we have no permanent enemies. We only have permanent self-interest." That is a proper and appropriate philosophy to live by. People have the right to their own self-interest. The role of government is not to dictate to people as to how to best utilize the energy that comes from that self-interest. The best way to do that would be to allow them to indulge in that self-interest.

Government officials are beginning to realize that one of the best things they can do is to keep the money in the country and let the entrepreneur use that money to create jobs, to create enterprises, and to make money because he is motivated by making money. Most of the entrepreneurs in Latin America have money in New York but that amount of money is diminishing as policy changes in those countries become hospitable to enterprise.

Any entrepreneur is not interested in only getting 5% from the bank. He's going to find some venture where he thinks he can make a 20% or 30% return. And in doing so, he then deploys that his capital and in doing so he creates jobs, and he creates an effect.

I may be wrong, but I can say that the Latin entrepreneur is as enterprising as an American or European entrepreneur. An entrepreneur is an entrepreneur. It doesn't matter which nation he is in or what country he is involved. If one treats them fairly, you will see the results of it, and I think that's beginning to happen in Latin America.

The top-down form of governance historically found in Latin America is changing. It is now beginning to be recognized by the politicians and others in that game, that the best way to do that is to allow the economy to operate. Bribery is a very common practice in the region but it is diminishing because a free economy gives you the sense that anybody can go out and do it. The minute you make the economy restrictive, you create a situation for corruption. The minute you allow the markets to work, the corruption disappears. That is allowing people to make their own decisions with their own money as they see fit—not protecting them by way of corruption, not protecting them by way of lobbying, or anything of that nature, but allowing the markets to work.

Latin America is fortunate in many ways because it's under the United States' military umbrella. There is no threat to Latin America from any foreign country. The nations don't have to spend any money on defense. Every once in a while politicians in the region might whip up some conflicts among each other for their own purposes, but the truth of the matter is that there is not a single dominant military force in Latin America. The Brazilians are not interested in invading Chile. They are not interested in invading Bolivia. They have enough on their own plate. They are big enough—as big as the U.S. They are interested in what is happening within their own borders and there is more than enough to do within their own borders.

What has to happen there, and is happening throughout the region, is the reshuffling, the allowing of individual incentives and energies to be freed in a way that is fair. I'm not suggesting that there shouldn't be any social or other commitments on the part of government to help those who are not as fortunate as others, but it is much more along the model of the United States—that of a free-market model.

The free market models, however, have a certain amount of volatility whether you like it or not. That means it produces economic cycles. These economic cycles are going to occur regardless of whether they are in the U.S. or whether they are in Europe, or anywhere else in the world. They will happen whether we like them or not. It does not mean that there is an absolute political solution, but you don't throw out the baby with the bath water because it doesn't work. I have been in this game for a long time and I have not seen that the laws of these cycles are going to change. At this point we are living at the very top of an economic boom. It will probably go down from what it is—not necessarily to what it was 25 or 20 years ago, but it will go down. If we take a number of 100, it may go down to 75, and then go up again to 125. On a cyclical basis, it will continue to do so in the next few years. The down cycle may last four or five years, and then a flattening out takes place for another four or five years. And then the cycle begins all over again and

then you have it for 10 or 15 years. That is the nature of the way the economies work.

Latin America is on its upward cycle. It is going to be like a samba—three steps forward and two steps back. But it will not stop it from going in the direction it wants to go. It will happen because the forces of human energy, effort, and incentive are always personal. We are driven. Some people like to collect art; some families will invest a great deal of money or personal income on the education of their children; and some families do not care about it. It is a very personal thing. But as long as you have that freedom—the right for them to choose—that's democracy.

I have been down in the region and I will say this—Latin America, within the next 15 to 25 years, will emerge as a major player. ●

Peter Gruber is president of Globalvest Management Company, LP, a SEC-registered investment adviser. He was a registered securities broker on Wall Street and worked for a member of the New York Stock Exchange. He became a principal in his own securities firm and gained significant experience in all areas of the securities industry. Beginning in 1964, he became active in corporate reorganizations. The companies with which he has been associated as a substantial stockholder have included Clinton Engine Co., Erie Forge and Steel Co., and McKinnon Structural Steel Co. Ltd.

Since 1977, Mr. Gruber has been investing in the securities markets of Latin America, Asia, and Europe, making him a pioneer of global markets investing. Peter is widely recognized as one of the leading developing markets money managers in the world. He has managed top-performing investment strategies in global markets for over two decades—through the thinly traded and widely ignored markets of the 1970s, the debt crises and political turmoil of the 1980s, and the rapid-paced transformations in those markets in the 1990s.

In 1991, for the purpose of accommodating additional and existing clients, its flagship Fund, Latinvest Fund, Ltd. was founded.

Globalvest Management Corporation was founded in 1992 by Mr. Gruber to offer investment management and advisory services to qualified U.S. investors, pension funds, and other institutions. In July 1995, Mr. Gruber relocated to St. Thomas, U.S. Virgin Islands, where he established Globalvest Management Company, LP. Mr. Gruber's expertise combines hands-on management and Wall Street investment banking experience, financial analysis, and money management.

The Fundamental Potentials Are Here

Ernesto Zedillo, Center for the Study of Globalization, Yale University | May 19, 2005

There is some good news and certainly some not so good news about Latin America. Let me start with two bits of good news: one in the long-term and the other in the medium-term perspectives. Overall, there have been significant improvements in Latin America. If one looks back to the situation we had only 20 years ago, improvements have been dramatic—not only on the economic front.

On the economy, we might think that things have not been particularly bright for Latin America over the past few years. However, if one goes back to the situation in the 1980s, particularly the mid-1980s, one should recognize that the economic transformation of Latin America has been very significant. Latin America was a region of very high inflation, in fact, hyperinflation in some countries. Latin America was the land of an overwhelming government presence in practically all economic activities. This caused chronic, and even dramatic, fiscal problems that constantly triggered financial crises. Latin America was a place where you could never say when the next financial crisis was going to explode, simply because the fundamentals of our economies were always, or most of the times, wrong. That has changed and we have gone through significant processes of reform in every aspect. That's the first good news.

Our economic policies are much sounder than they used to be.

The other positive news is that 2004 was a good year for Latin America, after a few years of rather stagnant or at best mediocre economic growth. Latin American economies grew 6.1%. There were some outliers like Venezuela, which grew substantially, but its economy had fallen a lot before as well, so do not be that impressed by the 70% growth of the Venezuelan economy last year. Venezuela's growth was helped because of the price of oil and because the nation was coming out of a recovery. You also had the cases like Argentina, which I think grew 9%.

Most significantly, the Brazilian economy, which had been practically flat for a number of years, finally grew more than 5% in 2004 and the Mexican economy grew more than 4%—something that had not happened since 2000. In my last year as president, the Mexican economy grew 6%. The Chilean economy did very well again, too. I think it grew a little bit more than 6%.

Brazilian President Luiz Inacio Lula has been a very impressive president. He has combined the right policies with the political talent to implement policies. Brazil is doing well. It is not yet there, but has been moving very fast over the past two years. If this continues, then Brazil is going to become not only the major player they want to be in the world economy, but I think it is going to be an extraordinary example in Latin America.

Chile has been doing well for 15 years with democracy. It has been applying the right policies and institutions and everything seems to be moving in the right direction. The problem with Chile is that it is perhaps too small to be influential in the region. Only when Brazil really starts doing well will the others follow that lead. I don't even think that Mexico could do it. Culturally we are closer to the South, but geographically we are next to the United States. So the region tends to dismiss Mexico's example.

Countries continue to reduce inflation. This is extremely important because Latin America was a high inflation region of the world. We still have higher inflation than our trading partners, but I think progress has been extremely significant

over the past few years. Our economic policies are much sounder than they used to be, and there are some institutional features that are very important such as the generalized independence of central banks. The targeting of inflation has proven to be quite successful, and flexibility in exchange rates has given Latin American economies an endurance and resistance to shocks that we did not have before.

There are other significant events in 2004. Exports grew 20% and direct foreign investment into the region recovered dramatically—by more than 30%. About $50 billion in foreign investment has poured into Latin America. Portfolio investment also grew significantly and lending to Latin America started to recover significantly. The vital signs are there—they are very positive. That is the good news.

The vital signs are there—they are very positive.

The fundamental bad news is that we are not yet there. Our economies continue to be vulnerable. We do not yet have the structural capacity to say that we could resist a significant slowdown in the global economy. We are at risk of seeing—if not this year, probably next year or the following—a significant slowdown in the global economy and that will affect Latin America significantly.

We are certainly extremely vulnerable to increases in interest rates. It is not a question of whether this will happen or not. It will. The question is when. The existing global imbalances are not going to be corrected without a significant adjustment in interest rates. When that adjustment happens, economies like the U.S. economy are probably going to have a severe cold, if some additional strength is not acquired between now and then. When the United States gets a bad cold, Latin America gets pneumonia. So, we continue to have structurally weak economies with significant structural deficiencies. And that, I think, is the bad news. The good news is that we have gone a long way; the bad news is that we have not completed our homework. That is the big challenge in Latin America.

The challenge is even more complex because, after all these years of adjustment, and some years—although not so many—of reform, people have started to speak about things like "reform fatigue" or "reform hangover" in Latin America. Some people have even started to question the wisdom of some of the reforms that we undertook back in the early 1990s and late 1980s in Latin America. And they are saying that maybe we were wrong in doing some of the things that we did. There are even highly respected scholars, even in this country, that are beginning to advise our Latin American countries to go back to the old policy ways that were so disastrous in Latin America.

Not surprisingly, and more frequently than not, you will hear again about populist politicians, either from the Left or from the Right, that prescribe these absurd policies that were proven so wrong in Latin America. Unfortunately, these populist politicians have started, in some countries at least, to gain some ground and win elections, either local or national.

Latin America is going through an identity crisis again. And this is perhaps the most serious problem that we now have to solve. Are we really going to assume the true consequences of a modernization model in Latin America—both economic and political? Or, are we going to look again to the past and start making the same mistakes we made in the previous decades. This is going to be the big political debate. This is going to be the big political question, and also the big economic question in the years to come in Latin America.

The Mexican economy is not going to endure any significant shock because of the political transition next year. This government has been prudent; it basically kept my economic team. We have a totally flexible, market-determined exchange rate. We have inflation targeting that has been applied very systematically by the central bank. I wish I had received a country like that 11 years ago!

In that respect, the country has kept what I called the armor of the economy. Three years before I left office, I said we have to end this curse of a financial crisis every time there is a change in government in Mexico. You go back to Mexican history—it was like that for a quarter of a century. The only way that we can do it is to armor the economy to be ready for the political shock. And we did.

Today, the Mexican economy is at least as good as it was in 2000, and perhaps even better because we have lower inflation and we have learned better how to work at the central bank and did many things that we didn't really know to the full extent five years ago.

What is my view of this process? I am hopeful. I do not expect a big bang in Latin America—that suddenly we will all be so enlightened that one day we will wake up and start doing what Prime Minister Lee Kuan Yew did in Singapore in the 1960s: fixing everything just like a big machine and putting the right things together. Actually, we have the potential in Latin America but I do not think that is going to happen. It is not going to be a revolutionary process.

We are going to see a process of gradual realization that there is no other alternative but to continue the path of economic and political reform. We are going to see Leftist and Populist governments rising to power, and

then realizing that if they go the wrong way they will pay a very high price.

Latin America is probably not going to go back to the authoritarian ways of government. Venezuela will continue to be an exception to the rule. It will continue to be an exotic exception as long as the price of oil is extremely high. Once the price of oil drops, then Venezuelans will start thinking more seriously about their government and something through the democratic means will happen. But I do not expect there to be a significant reversion in any way to the old authoritarian regimes that were so pervasive in the region.

The fundamental potential of Latin America is very significant.

I am really pessimistic about the medium term, because we will not see spectacular achievements in Latin America. We will continue to see a widening gap between Latin America and other emerging regions in the world. But in the long term, I am fundamentally optimistic. I expect that little by little, the necessary reforms will be introduced or will be continued. There will then be a tipping point at which we will have the necessary critical mass, and we will start seeing the generation of higher growth and even greater political stability and significant progress in our social indicators. I only hope it doesn't happen in the too long term.

The fundamental potential of Latin America is very significant. The sheer size of Latin America is very important. These days, everybody talks about China. I am a great admirer of what China has been doing over the past 20 years, but people should be aware that China is not the only game in town. In fact, the Latin American economy, seen as a whole, was bigger than China in 2004. China has a GDP of $1.6 trillion; Latin America has a GDP of $1.7 trillion. Probably in the next two or three years China will be bigger, but our base is actually pretty solid. Sometime in the medium term, the Latin American economies will certainly start growing at a much faster rate.

What do we need to get there? I could spend hours speaking about specific policies. And I could tell you we need fiscal consolidation, to the point at which we can have counter-cyclical fiscal policies, and at the same time have the capacity to increase in two or three points of our GDP expenditure earning per structure. Of course, we need to continue strengthening our financial system. Some countries have been doing a good job, like Mexico, after the tremendous failure that we had. After the private recession of the banks, our financial system is now beginning to do very well, as in Chile and other countries. And we need to open our economies more.

We need much more economic integration, economic inter-dependence, and globalization. One of the problems that we have, particularly in the southern zone, is this tendency to keep their economies closed. Other than Chile, Brazil and Argentina are still too closed to trade and investment. We need more integration; we need more inter-dependence, we need more globalization.

Probably, these policies will be very controversial for some people, and that is part of the debate in Latin America nowadays. The debate on specific policies has, perhaps, gotten to the point at which it is not so relevant. It is well understood what we must do. But the big question is why we are not doing it right? That is not an economic problem.

Even the most radical people against the so-called Washington consensus recognize that there is no alternative to fiscal and monetary responsibility. They would be ill-advised to adopt exchange controls or fixed-exchange rates. You need flexibility in your labor markets. There are no fundamental disagreements about economic policies.

And even if there are, those disagreements can be fixed. So the question is why we do not do it! We do not do it because we have not come to a more fundamental agreement on the political front. We can not seriously debate economic policies because every political party is going to have its own proposals. But at the end of the day, they will not honor those proposals in practice, because somehow the system does not deliver the capacity to implement those policies to the full extent. So where should we find that agreement?

Perhaps you will be very surprised when I say that the fundamental problem of Latin America is not that we have the wrong policies, but rather that we have very weak states. Many thought that Latin America had these overwhelming states and that is why we privatized. No. For a long time, we Latin Americans thought that compared with other emerging regions of the world, we had strong states. And we were confused about that for two reasons. First, leaders had significant personal power. I can tell you—I was one of them. Personally, I had a lot of power. I had to restrain myself from Day One! Second, this overwhelming presence of our governments throughout our economy created the idea that the state was strong. Well, when we moved into democracy fully and when we adjusted our economies, we figuratively undressed the king! We discovered that we really had weak states.

Why do I say weak governments? You have a strong government or a strong state when you are able to do two things: one is to have the monopoly of force to enforce the rule of law and the second is you are able to tax people to sustain the state in its essential functions.

If you look at these two indicators of strength that apply globally we don't pass that test in Latin America. We do not have universal rule of law—we have a very weak rule of law. The state does not have the monopoly of force. There are too many other forces trying to exercise and impose their own rules on the rest of the society.

Furthermore, we have structurally weak fiscal states. We do not have the economic capacity to deliver the essential functions of the state. If politicians in Latin America came to an agreement on this point, then it would be possible to build a fundamental consensus. We can fight about fiscal, monetary or trade policies, whatever. But you know what? Let's get our states to be able to apply the rule of law. Within that, of course, is the problem of corruption and property rights. And if we give our states the minimum fiscal capacity to execute their fundamental functions, that can be the beginning of a real consensus. After that, the application of the policies will be rather straightforward.

I insist this is not going to happen in a revolutionary way. It will happen in the coming years, and at that point we are going to have a tipping point in Latin America. And the development of Latin America can be spectacular. ●

Ernesto Zedillo is the director of the Center for the Study of Globalization and Professor in the Field of International Economics and Politics at Yale University. He was President of Mexico from December 1994 to December 2000. After leaving office, President Zedillo became chairman of the U.N. High Level Panel on Financing for Development and was a Distinguished Visiting Fellow at the London School of Economics.

He served as co-coordinator of the U.N. Millennium Project Task Force on Trade and was co-chairman of the U.N. Commission on the Private Sector and Development along with Prime Minister Paul Martin of Canada. He is currently chair of the Global Development Network and co-chairman of the International Task Force on Global Public Goods.

In April 2005, President Zedillo was appointed by the U.N. Secretary General to serve as his envoy for the upcoming September 2005 Summit in which heads of state and government will review implementation of the Millennium Declaration.

President Zedillo is also a member of the Trilateral Commission, serves on the International Advisory Board of the Council on Foreign Relations and the board of directors of the Institute for International Economics, and is a trustee of the World Economic Forum.

He earned his undergraduate degree at the National Polytechnical Institute of Mexico and his Masters and doctoral degrees at Yale University.

Know When To Enter But Have An Exit Strategy On Hand

Marshall Goldman, Wellesley College & Harvard University | June 17, 2004

Are the huge Russian returns we have seen something that was there for the pioneer but not for the follow-up investor? Russia is a land of great opportunity for investors and greater risk. Enormous fortunes have been made, lost, and then made again. Sometimes the loss takes place in the loss of a life, or a threat against a life.

What I want to talk about first of all is the securities market, then the climate that currently exists there, and then the consequences of ill-defined property rights in Russia. Yes, I am a bit of a pessimist: I was once introduced as the "Doctor Kevorkian of Russian studies." I think that is basically my function here.

There is enormous volatility in the Russian stock market. If you bought a basket of stocks, mainly energy companies, and stayed in it, you would be OK because it started out in 1996 at 100 and even now it is above 500. But the upside and the downside are extreme. In 1996, you bought at 100. By October 1997, it had reached 585—a five-fold increase. But by Oct. 5, 1998, the index had fallen to 39. As of April 2004, the index had risen to 785. Again, you would have looked like a hero. By June 17, it is down to 533—a one-third drop in just two months. The trick is to know when to get in—the harder trick is to know when to get out.

This leads to concern. In 2004, largely because of YUKOS Oil Co., the distrust of the market led to another sort of crisis. The Russian Central Bank revoked the license of Sodbusinessbank because it could not account for $1 billion in transactions. That set off a panic in the interbank rate. Banks failed to make their payments. Credit Trust Bank failed as well, and the interbank rate rose from between 2%-3% to about 30% overnight. The fiscal situation today is very different from 1998. The banking system was bad and rife with money laundering. Depositors were wiped out and Credit Suisse First Boston had to write off $1 billion. Here in Greenwich, Long-Term Capital Management was also affected. The government in 1998 was simply borrowing money to pay the loans that were never going to be repaid because people, including the oligarchs, were not paying their taxes. In 2004, bank reserves topped $90 billion. In 2006, they are approaching $300 billion, while in 1998 they were just in the tens of millions of dollars.

> When the oligarchs undertook the privatization of Russia, they also embarked on the piratization of Russia.

We now come to the question of property rights and here is where you get into the Mikhail Khodorkovsky situation. You have to understand something about the seamy background of the early 1990s and the faulty foundation that still exists. Until 1987, everything was owned by the state and there was almost no private net worth. When the oligarchs undertook the privatization of Russia, they also embarked on the piratization of Russia. They created banks that acted as their own personal ATMs and as lenders to the state. The state was not collecting taxes because the oligarchs were not paying it, so the state had to borrow money. The oligarchs offered to lend them the money through their banks and took companies that had not yet been privatized, some of the main oil and gas companies, as collateral. When the state failed to pay back the loans, the banks auctioned off the stock of the companies. The auctioneer had rigged the auctions, and turned out to be the winner. This was how Khodorkovsky, the imprisoned YUKOS owner, paid about $310 million for a property that was quickly evaluated at $7 billion. Boris Berezovsky, now in exile in London, paid $100 million for Sibneft, a large oil company that was headed by Roman Abramovich, the man who bought the Chelsea football team in London. That was worth about $3 billion. Abramovich in turn sold Sibneft to Gazprom for more than $10 billion. He can afford to buy a whole soccer league. You can understand

why there is anger within Russia—$100 million paid for a $3 billion company.

According to a 2004 *Forbes Magazine* issue, there were 36 billionaires in Russia. Moscow had 33 alone—more than there were in New York City. These were not self-made people. These people basically took over state assets and claimed them as their own. The government is understandably eager to bring these people to justice in order to satisfy the public urge for anger.

Until 1998, there was very little restructuring and very little value added from these people. They simply took these assets and made their money when the oil prices jumped from $10 a barrel to $30 a barrel. To gather all this property, they had to cut an enormous number of corners. Berezovsky once said, "No one can operate honestly in Russia... even though the laws at that point were really very loose and have been tightened up some. You just could not operate legally."

For example, there is a law that says jewelry stores must have bars on their windows. But the fire laws say jewelry stores can not. The only way you can do this is to bribe somebody or hire the Mafia. When self-made Russians ask me where I would invest my money, I tell them to go outside the country. If they do, that complicates President Vladimir Putin's effort to double the economy because Russia needs domestic investment to grow.

That brings me back to the property rights situation in 2004, and YUKOS is the best example of what can happen given this faulty foundation. Its bank assets have been seized; taxes have been seized; and offices are raided on a continuous basis. The senior staff is either in jail, in exile, or finally released after paying a couple of million dollars to the state for past claims. The state also transferred YUKOS' drilling rights to one of its competitors in Yakutia, the Republic of Sakha.

Russians have a knack of rescuing defeat from success.

Other examples of the uncertainty of property rights abound. UES (Unified Energy System of Russia), the main electric generating monopoly, had its biggest hydroelectric facility renationalized for a time. VimpelCom, a self-made mobile phone company, had its license transferred to a company owned by the Minister of Communications for a while. We think Exxon-Mobil has just had its license revoked to operate in Sakhalin-1, an oil field on Sakhalin Island in the Russian Far East, because the oil company was criticized for not putting enough money inside of Russia. Sawyer Research from Cleveland, Ohio lost a $7 million-$8 million property

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An internationally recognized authority on Russian economics, politics, and environmental policy, he is known for his study and analysis of the careers of Mikhail Gorbachev and Boris Yeltsin. And has met several times with Vladamir Putin. Professor Goldman is the author of more than a dozen books on the former Soviet Union.

Professor Goldman writes frequently for such publications as *Current History, Foreign Affairs, The New York Times, The Washington Post,* and *The Harvard Business Review.* His articles have also appeared in *The New Yorker, The Atlantic Monthly,* and *Science*. He has appeared on CNN, "Good Morning America," "The Lehrer News Hour," "Crossfire," "Face the Nation," "The Today Show," and "Nightline." He has written regularly for the Russian newspapers *Moscow News* and *The Moscow Times* and is often heard on *National Public Radio*.

Professor Goldman is a 1952 graduate of the Wharton School of the University of Pennsylvania and received Masters and PhD degrees in Russian studies from Harvard University in 1956 and 1961. He was awarded an honorary Doctor of Laws degree from the University of Massachusetts Amherst in 1985.

they had built up in the city of Vladimir. A Canadian firm, Norex, had its $1.5 billion property taken over by TNK (Tyumen Oil Co.). SUBWAY, a fast food chain, which opened a joint venture franchise in St. Petersburg, was booted out of Russia when it turned out its partner was a local Mafia head. SUBWAY was able to get back into the country in 2004 but only after the intervention of President Bush. And as far as the television stations go, Berezovsky had his property taken away.

Russia has enormous potential, I do not want to deny that. But the Russians have a knack of rescuing defeat from success and they've done it over and over again. So the question is whether they have learned from their experiences. Russia is investable but the key is to know when to get in and when to get out. You also have to be very sure that you know who your partners are. The Russian government is trying to make the laws more and more durable, but unpleasant surprises still creep in. There are possibilities and there is enormous human capital. However, the YUKOS situation is indicative of serious problems. Some say that YUKOS is the worst there will be—but I don't accept that. ●

Capital Starved And A Good Value

George Siguler, Siguler Guff & Co. | June 17, 2004

Our firm, Siguler Guff & Co., is the largest private equity manager in Russia. We have had our successes and our failures, but on balance it has been a positive experience. We look forward to investing further there for some fairly fundamental reasons. Our fundamental guess was that if Russia worked, it would turn into five Canadas. Russia is not going to be China or India; it will not be a low-cost manufacturer. We did not see large amounts of technology to transfer. Instead, Russia would export energy, natural gas, and oil, and at some point, would export agriculture. With that and the wealth associated with that, it would build a society where the service sector and the consumer will catch up for 80 years of pent-up demand for consumer goods.

We have seen an enormous change. Moscow is a very, very vibrant European capital city. Wealth creation is everywhere, and it is expanding rapidly. As in much of the emerging world, Russia is also leapfrogging to current technology. In the Soviet era, there was no retail to speak of, and now, retailing has become big bucks. The Ikea stores near the airport are huge. Hypermarkets—European-style Wal-Marts—are all around the ring road. There are 32 million cell phones in Russia, up from a couple million four or five years ago.

> Moscow is a very, very vibrant European capital city. Wealth creation is everywhere, and it is expanding rapidly.

Over the years we have certainly taken our lumps, but the fund is near its final maturity now. Its returns have bounced back significantly. While 1998 certainly cost us a couple of companies, it was not like an Asian or Latin American crisis because there was little or no corporate debt in the system. It was an equity and a dollarized economy; so as a consequence, we were able to ride through most of it. We lost two significant businesses—we were owners of the largest poultry and beef importing company at the time, bringing in Western products. When the currency was devalued by 75%, even though we had dollar receivables, the seven-day credit extension basically wiped us out. We also had a medical-supply business with similar problems.

On the other hand, our pulp and paper business where we had ruble costs and dollar revenues saw the opposite effect. So net, the fund is about three times right now, returns are in the mid-20s, and we found Russia to be a pretty investable place. In the case of the pulp and paper business, we paid $75 million; partially stock purchase, partially privatization purchase. Lots of ancillary businesses were attached, including chicken farms, hotels, apartments, kindergartens, and clinics. We privatized all the ancillary businesses into the hands of the employees and took our employee count down from 12,000 to 5,000. We received an Export-Import Bank loan to convert one of the five paper machines from newsprint to A4 copy paper because there was no major copy paper manufacturer in Russia. EBITDA went from $15 million to $120 million. Our company was competing against International Paper in the end. We sold it four years later for $400 million to Anglo-American using a basically Western format transaction. It has been a largely successful enterprise.

We founded and own MTV Russia. We wanted to own broadcasting assets back when you could create a TV station for the cost of a transmitter. In TV, content cost goes up with the revenue line, and since most of the content would have to be purchased, we were looking for fixed-price content cost. Nothing was better for fixed-price content than music television. MTV has performed as expected. Once we covered fixed costs, margins were everything except ad sales commissions. MTV Russia is the fastest growing MTV in the world. We have 16 owned and operated stations and 75 affiliates, and a profitable business. We started with a franchise and a license with Viacom; they now own a large minority position.

We rolled up three cement plants and a distribution company to create the largest cement company in Russia. In emerging markets, cement is a growth stock and our enterprise does $40 million effective post-money valuation on $100 million in EBITDA this year. We've changed management twice, and were a large minority shareholder, not a control shareholder. Still, we were able to effect management changes, and the company is chugging along.

Each step was different. There was privatization and there were deep discount transitions of large capital-intensive businesses. Today we see many intermediate-sized businesses without access to growth capital. Now, with Warburg Pincus, we are buying radio stations and aiming to create the Clear Channel of Russia. I can buy radio stations at three times cash flow, up, and running profitably.

When we entered the market, our ROI criteria varied—for an easy deal it ought to be five times and a tough deal ought to be 10 times. And, I did not know how long it would take to exit. Now it is more expensive, but you are buying off of cash flows. In radio, ad revenues from 2000 to 2004 in Russia went from $760 million to $3.2 billion: unit cost for advertising is growing at 20% a year. If you can buy a radio station at three times cash flow, where top line is growing at 20% a year, and you can leverage it, it doesn't take you long to get to five times. Russia has yet to develop nationally branded consumer products. It will not be a mature business as in the U.S. in the 1950s, but rather an indigenous product with a Russian label on it. You could roll up three manufacturers and put that strategy in place and execute on it.

As a registered investment advisor, I live and die by the Foreign Corrupt Practices Act. Without it, I would be out of business in a minute. We use Western counsel—most of our counterparties are also Western counsel. We have Russian commercial code but also have fairly encumbering shareholder agreements, and we enforce shareholder agreements, even in contentious situations. Due diligence is different in Russia. When you size up partners, you need to know how people got to where they are. It's transparent in different ways. You can find out everything you want to know about somebody one way or another. The country watched each other. And you want to know how people are behaving. You have a lot of time to do due diligence. We think we can get to the bottom of most situations, and we walk away from things where we do not like the people or the structure.

When you size up partners, you need to know how people got to where they are.

In 1998, we took over three other funds that had gotten in real trouble. The managements had a mess on their hands. In each case, the limited partner or controlling shareholders asked us to step in. We worked those portfolios through and created multiples off the value we bought in at. We closed our latest fund in April 2004 and have raised about $230 million out of the expected $400 million. Our capital is seen as value-added capital. We have access to Western exits, so we like doing strategic things with a Western company in the transaction as well as our own. If a Western company is interested in acquiring a Russian asset, it takes comfort that there was a Western owner there before. Some owners have residual concerns about their shareholder ownership. They are worried that larger, more powerful groups would challenge their ownership. They can take comfort in our capital because we are effectively an element of political cover. Backers of our next fund include Overseas Private Investment Corp., the European Bank for Reconstruction & Development, and the World Bank. I am not sure this political cover is necessary, but people feel comfortable having it.

We look at private equity quite differently than public markets. Public markets are driven by oil, gas, minerals, and maybe a cellular or consumer products company. They do not represent the economy. The energy sector makes up more than 75% of the Russian stock market and that adds the volatility of $12 barrel versus $40 barrel oil to the political volatility. Also, the effective float of the Russian stock market is about the size of Yahoo. Considering this, the volatility is not so surprising—you are in one industry with huge price volatility in not the most politically stable place in the world, with very thin liquidity. It has very little to do with fundamental investing in Russia as we think about it growing in a capital-starved economy. The oil sector is a political fight. How Mikhail Khodorkovsky gathered those assets is a long-term challenge for Russia to overcome. He

basically said, "I'll run my old company for two or three years and then I intend to be the leader of this country. And by the way, Mr. President, I can stop today any bill you want to get through the Duma." There was no vote he could not have for $5,000. Sometimes he could buy both sides for $5,000 a vote. If one businessman could do that in the U.S., we would have a Constitutional crisis.

It is not good to have a society of 150 million people where five or six people control that much wealth. As a result, I do not like the Russian stock market because I find it under-diversified in a politically sensitive sector. On the other hand, it has very little to do with the fundamental growth of an economy of fairly well-educated people who have wants and needs and a huge capitalistic spirit. There will be a stock market there that works. We are all looking at stock market exits. But for the time being, and maybe for the rest of my life, Russia will be capital-starved and good value. ●

George Siguler is a founding principal and managing director of Siguler Guff & Co., a multi-strategy private equity investment firm with more than $2 billion in assets under management. The firm was created in 1995 following the spinout of the private equity group from the Mitchell Hutchins Asset Management division of Paine Webber, which he had headed since 1991. The company has a successful track record acting both as principal investors in creating and managing private equity partnerships, and as an advisor acting on behalf of clients as a limited partner in industry leading funds. The firm serves as general partner, manager or co-manager in 10 direct private equity partnerships and limited partner in over 75 partnerships.

Before joining Mitchell Hutchins, Siguler was president of Associated Capital Investors (formerly Bank America Investment Management Company). Mr. Siguler was a founding partner of the Harvard Management Company in the early 1970s, and initiated and managed its venture capital, buyout, and hedge fund activity. He also served as associate treasurer of Harvard University and also served in the Reagan Administration as chief of staff of the U.S. Department of Health and Human Services.

Mr. Siguler has served as a director of Commonfund Capital, the private equity arm of The Common Fund, and was a member of the Board of Overseer Visiting Committee of The Harvard Medical School. He is also a trustee of the Bement School, Deerfield, Mass. Mr. Siguler is a graduate of Amherst College and The Harvard Business School.

Weathering The Nation's Volatility

Frank Mosier, Kazimir Partners | June 17, 2004

Russia has a unique ability to surprise and in fact out-perform expectations. Things have happened quickly in Russia after 1991 when the Soviet Union collapsed and Russia was reborn. Capital markets began in Russia in 1993 with voucher privatization, and in 1996, VimpelCom was the first Russian company to go public on the New York Stock Exchange. That demonstrates to some extent how Russia can surprise and out-perform. To some extent, VimpelCom has continued to out-perform, albeit with the volatility.

Russia today is at a significant inflection point in its political and economic development, and we believe in the ensuing long-term convergence of Russian asset prices to levels in other emerging markets and Organization for Economic Cooperation and Development countries. We know that historically emerging markets on the cusp of significant positive political and economic change have been among the most profitable investments in the world.

I was on an airplane with one of Vladimir Putin's chief economic advisors the day after Ronald Reagan died and I caught him reading the obituary. We talked about Ronald Reagan. There are many Reaganites, believe it or not, advising the current government. Here are a few facts: Russia has a 13% flat personal income tax; a federal budget surplus of 2.4% of GDP; and real GDP growth in excess of 5% since 1999—about 7.5% in 2004. Also, there is a current account surplus of $11 billion and gross international reserves that are approaching $100 billion. Things have very much changed since 1998, and the current situation is extremely benign. I would argue that aside from the growing pains associated with enforcing the law and creating a more law-abiding society and environment, the current government is the most competent and reform-minded that we have ever seen, and the potential is extremely significant.

One reason our fund exists at all is because we were looking for a place to invest in Russia without the extreme volatility.

What kind of money can be made from this? In 1994, the public equity market appreciated 620%. From 1995 to the end of 1997, it appreciated 2,468%. From the low in 1998 until the end of May 2004, it rose 1,364%. That sounds great, but what I did not tell you was what happened in between. Volatility is the most significant risk. If you look back from the beginning of 1994, which was when the public markets effectively started to be tracked through the CSFB ROS Index, until May 2004 the average annualized return is about 62%. The annualized monthly volatility, however, for that same period is 77%. That is not a good trade.

One reason our fund exists at all is because we were looking for a place to invest in Russia without the extreme volatility. Most of our peers are still country funds and they're essentially long only. One of the largest investment funds in Russia and better performers has annualized returns of 33% and historical volatility of 48% and that is only from 1996. That, in my view, is not a very good trade.

In addition, there are periods of extreme volatility: once the market dropped 58% in one month in 1998 during the financial crisis following the ruble devaluation and debt default. In October 2003, when Mikhail Khodorkovsky, the CEO of YUKOS Oil Co., was arrested, the 10-day price volatility was 80%. In the first 20 days of October 2003, the RTS Index was up 12%. In the last 10 days of October 2003,

it was down 22%. In the month of October 2003, YUKOS was down 32% peak-to-trough and it subsequently dropped 27% in April 2004 and 31% in May 2004. This volatility is extreme, but if you can take out the periods of severe negative volatility, our experience has been that you can substantially increase long-term returns and reduce long-term volatility. Lack of liquidity exacerbates this volatility. The market capitalization of the RTS Index, which is the broader market index in Russia, is less than $150 billion today. For example, LukOil, one of the largest companies with a market cap of about $23 billion, trades on average between $70 milion-$100 million a day. That is not a lot of liquidity.

What is the right strategy for mitigating this volatility? You can imagine the experience in 1998 went a long way to crystallizing how everybody understands risk management. The long-only strategy of the past—the dedicated country funds—suffered the most volatility. We prefer a combined strategy to maximize returns as well as manage risk in order to reduce long-term volatility. This strategy comprises several components.

First, a balanced analytical framework that includes both top-down and bottom-up analysis. Second, sufficient domestic information flow allows you to have a window into politics, but also know what is going on at the company level in order to anticipate events both at the corporate and at the macro level, that will influence your market view. Third, unlike most investors in Russia, we take the view that you have to know what is going on in Washington, Buenos Aires, and Beijing in order to manage your portfolio in Russia. And we have certainly experienced periods—1998 is the glaring example—when things that were happening outside of Russia had an enormous influence on what happened inside Russia. Fourth, you need to have an active trading component that allows you to manage the short-term risks and reduce the volatility in certain periods. Sometimes you have higher turnover; sometimes you have lower turnover, but it boils down to a flexible capital allocation model that allows you the ability to short specific names, the ability to short the broader market, and most importantly, the ability to be significantly overweight cash, particularly in periods of extreme negative volatility. If you implement that kind of strategy, you can achieve returns in excess of 30% with less than 20% volatility. We believe that this is a superior strategy than the long-only funds, and I think that's a better way to trade Russia.

We have certainly experienced periods—1998 is the glaring example—when things that were happening outside of Russia had an enormous influence on what happened inside Russia.

What is our near-term view and how should you trade it? The situation in YUKOS is likely to deteriorate further. There will likely be increased volatility as Khodorkovsky and Alexander Lebedev are likely convicted and the tax payments likely enforced. This may lead to certain large Western minority shareholders reaching a stage of capitulation or near capitulation and we have seen some indication

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of that over the last several trading sessions with bids going away in YUKOS and LukOil. Perhaps speculative or institutional money is attempting to reduce Russian risk. We are likely to see YUKOS go into receivership—that is different from bankruptcy—but it is a step in that direction. That is probably the perfect platform for a negotiated settlement, because it essentially provides a structure whereby anything can be implemented. I do not think that there's going to be a negotiated settlement prior to that, and a negotiated settlement in any event is extremely complicated.

In the medium-term, the resolution of the YUKOS matter and the resulting policy going forward is the most important issue from a macro perspective in Russia. The issues that we need to look for in making future investment decisions are: "How was YUKOS dealt with?" and "Does the resolution of YUKOS lead to further policy changes?"

I believe that there will continue to be actions against oligarchs and people in natural resources, but that they will be substantially less aggressive. You can't imagine a corporation in Russia today getting a tax bill and saying, "We're not going to pay. I'd rather go to jail." It is not very likely that we will see that. Therefore, with the resolution of YUKOS, we could see a steep decline in perceived political instability, and that will lead to a very good entry point in this market. ●

Editor's note: *On the day this speech was given, the YUKOS stock price rose more than 38% as President Putin announced that he had no intention of bankrupting the company. By the end of 2004, the stock had fallen 91% from its high that day and YUKOS had lost most of its assets (but was not bankrupt). In 2005, the ROS Index returned 64% as oligarchs started paying tax and the YUKOS saga ended. Since inception in August 2002, the Kazimir Russia Fund LP has returned 601% net, with average annualized returns of 55% and annualized volatility of 21%.*

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