THE GREENWICH Roundtable Letter

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SUMMER 2007 • Volume 5, Issue 2

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THE REVIEWS ARE IN AND IT'S A HIT.

The latest *Best Practices in Hedge Fund Investing: Due Diligence for Fixed Income and Credit Strategies* was published in June by the Greenwich Roundtable. The third in the series on *Best Practices,* it continues the organization's effort to demystify alternative investment strategies.

According to an article in *Pensions & Investments,* "the report at 68 pages, is not for the idly curious. Rather, it provides an in-depth analysis of the enormous variety of fixed-income and credit-oriented hedge funds, their origin and growth as a result of the rapidly developing credit derivatives market, and the issues investors need to consider before investing in a hedge fund in this asset class."

Policy makers are paying attention too: Since the publication of *Best Practices,* Chairman of the Federal Reserve and Secretary of the Treasury have been testifying before Congressional Committees about hedge funds. They have mentioned "Best Practices"-- clearly a reference to the work of the Education Committee. David Storrs' External Affairs Committee is visiting these influential policymakers throughout the summer.

Never before has so much institutional knowledge from experts in fixed-income and credit hedge fund strategies been housed in one place. Organized into ten chapters, the guide gives investors not only a roadmap on how to understand the key elements of these strategies, but also includes discussion on how to weigh the merits of what they hear about them from their managers. The study points out "red flags" such as inadequate back-office and operational infrastructure for range and volume of instruments traded; lack of independent pricing by an outside administrator; illiquid assets coupled with overly generous redemption terms and/or unstable capital base, and excessive leverage. In short, *Best Practices* provides an exhaustive, detailed guide to the due diligence process.

Aleks Weiler, Chairman of the Due Diligence Working Group, spoke of the painstaking process behind the report saying it was written collaboratively by 16 hedge fund professionals who spent countless hours codifying their knowledge and experience into a comprehensive analysis of *Best Practices* in this strategy.

Steve McMenamin, Chairman and Executive Director of the Greenwich Roundtable, profusely thanked the Due Diligence Working Group for their unselfish devotion to delving into the issues involved in these strategies. Spencer Boggess, chair of the Education Committee, hailed the "mammoth amount of writing, editing and research" done by the Group and its leader, Aleks Weiler.

The publication was launched at the Greenwich Roundtable's June Founder's Council where Stu Spodek of BlackRock highlighted opportunities and risks in global fixed-income markets, Brian Milller of Elliot Associates cautioned participants to expect a further deepening of mortgage market woes, and Claudio Phillips of Commonfud provided an insider's perspective on the workings of high-yield markets.

Prior "Best Practices" include *Due Diligence for Equity Strategies and Due Diligence for Global Macro and Managed Futures Strategies.* Continuing its educational mission, the next publication by the Greenwich Roundtable will be on portfolio construction.

Members of the Greenwich Roundtable have access to the publication and all previous *Best Practices* on the Roundtable's website at http://www.greenwichroundtable.org. Non-members interested in *Best Practices* and other resources of the Greenwich Roundtable should contact the GR Membership Manager via the website.

Happenings

Left to right:
Khaled Abdel Majeed, Paul Bate and Heather James

Left to right:
Edgar Barksdale and Jack Bogle

Left to right:
Eliza Pepper and Rian Dartnell

Left to right:
Michael Kosoff and Laura Fidao

European Activism: Locusts or Saviors?

Our session titled *European Activism: Locusts or Saviors?* is the third session where we examined public market managers who attempt to influence the outcome of their investments. In 1996 we heard Al Kingsley describe his efforts to persuade an Italian eyeglass maker to adopt his path to profitability. The eyeglass maker agreed, profits grew and the company was acquired at a significant premium. Last year we heard from Carl Icahn, Al's mentor, describe the fine points of his approach. Today we heard from 3 of the finest practitioners in the European theater. One manager wishes to remain anonymous (sorry but you should've been in the room for this guy). Guy Wyser-Pratte is a legend for good reason...he's a seasoned moneymaker and a gentleman…unless he's ignored. Christer Gardell acts as a venture capitalist in the public markets. Using skills honed at McKinsey, Christer helps his Nordic portfolio companies improve their operations and then their value to shareholders. Ted Seides organized and moderated this urbane look at a strategy that strives to add value beyond capital. ts@protegepartners.com

Guy Wyser-Pratte, Wyser-Pratte & Co

Europe is not an easy place to operate. Europe has no takeover code, no Sword of Damocles over management's head. Everyone is protecting their turf which makes it hard for strategic buyers to cross the border. Europe has no equity culture and very limited public share ownership. Labor is a big problem. In Germany, its presence on Boards and its immobility makes restructuring very difficult. The concept of one share, one vote does not exist. Multiple voting rights, priority shares, golden shares, and depositary shares all exist to limit shareholder rights. Holland is the worst offender. Its voluntary system has no enforceable corporate governance code. In Europe, shareholders are pitted against other stakeholders such as labor and suppliers. This is socialistic nonsense. The only group not protected by contract is the shareholders. They look to the Board for protection but most Directors do not own shares so their interests are not aligned. Politicians rally against activists and hedge funds. Attitudes toward wealth creation rest on premise if you made money, you made it illegally. Europe has many advantages. Scores of companies trade at significant discounts to book value and to potential restructured values. The obstacles I just mentioned create these discounts. Europe has no litigation culture and lawsuits are rare. Most big countries have no adequate pension schemes and limited local shareholder support. Thus most shareholders are Anglo-Saxon portfolio managers who make rational shareholder decisions. Most holders don't vote their shares or go to meetings. Thus a loose group of activists can organize a quorum. Activism in Europe requires flexibility and credibility. Credible activists will demonstrate their long term commitment and their willingness to work with management. If we can't persuade the management then we try to persuade the shareholder. We don't write nasty letters to shake things up just for fun. In the US, you can be a cowboy activist but not in continental Europe. We attempt to raise the tide for all boats, to make the situation better for all parties. For activism to work, first we attempt to identify the gap between the market price and the restructured value of the company. Then we identify the problems whether they are strategic, blend of assets, managerial, corporate governance, or shareholder conflicts. Finally we attempt to cure the problem to close the gap and realize the actual value. The media is always looking for a fight. They always approach us and we don't try to persuade them. We're honest with them and tell them what we're doing. We shoot straight, stay consistent and our rapport improves. Only then do they support our efforts. gwyser-pratte@wyser-pratte.com

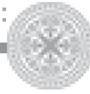
Guy Wyser-Pratte

Christer Gardell, Cevian Capital AB

When I described corporate governance in Scandinavia to Carl Icahn, he called it paradise. Our approach to this strategy is operational activism. We've been using this style for ten years. We are long term investors, holding shares for three to five years on average. We target undervalued large cap companies primarily in the Nordic regions. We look for valuation gaps and opportunities to enhance the business. We build significant minority stakes in a small number of companies. We have an extremely concentrated portfolio of five or six names. Then we get on the Board of Directors or the Nominating Committee to influence the value enhancement plan. We actively work with management and the Board to get action in a timely fashion. There are four ways to improve the effectiveness of the business. First is corporate governance. We try to ensure the Board and the managements are as strong as possible. We're not shy about making changes to either. Second is operational efficiency such as reducing costs and streamlining processes. Third is corporate strategy and structure. We try to ensure that investments are made to their highest utility and the corporate structure is adding value not destroying it. Fourth is capital structure. We try to make sure the company has an adequate capital structure. In the US this strategy might be viewed as hostile but not in Scandinavia. It is viewed as friendly because the corporate governance code is hierarchical, placing the shareholder at the top. If you increase shareholder value, you're friendly. If you destroy value, you're hostile. The nominating committee is independent consisting of the four largest shareholders. This committee evaluates the effectiveness of the Board and creates a proposal which is voted by shareholders. The Board is non executive for a one year term with responsibility for running the business. The Board appoints the management. In this structure, the CEO is not the king but an employee. In the market for underperformance, we are considered friendly. Those who under perform are criticized by the media. Fortunately, the Swedish press has supported the shareholder rights cause. They recently ranked me ahead of the prime minister in popularity. Guy was correct. Corporate governance in continental Europe is tricky. Overall, the opportunities are immense. Inefficiencies are plentiful in the large cap area. Relative to the small to medium cap companies, there are huge discounts. The growth in labor productivity in manufacturing is 6% in Sweden, 1.5% in Germany and 1.3% in Holland. Operational inefficiencies are huge and our strategy is slightly moving south. On the continent, short term investors are viewed negatively. There is a risk that these investors will harm the long term players. We think there is a movement of continental governance to move towards the Scandinavian model. There is pressure from the EU to break up the embedded inefficiencies. The new generation of managers is different. They've been brought up with the Bain, McKinsey and Anglo-Saxon methods. Activist investing in Europe is attractive. Competition is limited and it's still virgin territory. We need a longer lock-up because of our long term orientation. Thus we can't be forced to sell before our work is done. Getting control in the public markets is more difficult but it's much less expensive than a private equity auction. We also don't need the ten year lock-ups that most buyout funds take. Christer.gardell@ceviancapital.com

Christer Gardell

Please join me in expressing our gratitude to Steven Winter, Kevin O'Brien and their colleagues at Bank of America's prime brokerage group for underwriting today's symposium. They, like the other 3 members of our Underwriter's Council, believe in "raising the bar" and educating investors. Steven and his group are doing outstanding work for the greater good. steven.winter@bofasecurities.com



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Weighing the Needs of Investors

Our session titled *Weighing the Needs of Investors* is the second session where we examined the issues that affect investors. Jack Bogle of Bogle Financial Market Research Center, one of the most vocal investor advocates in the world, founded Vanguard Group in 1974 which grew into one of the two largest mutual fund companies in the world. Jack is the father of the modern index fund and is a legend. As a proponent of passive investing, he confessed to feeling a bit like Daniel in the lion's den, being surrounded by so many investors who built their portfolios with active managers. Ed Barksdale of Federal Street Partners moderated this discussion. Although it was lively, we let this distinguished gentleman leave in one piece. ewb@federal-street.com

Jack Bogle, Bogle Financial Research Center

The reality is that gross returns in the financial markets minus the cost of financial intermediation equals the net return delivered to investors. Staggering amounts of financial literature are devoted to the efficient market hypothesis (EMH), but almost no attention is paid to the CMH, the cost matters hypothesis. No matter how efficient the market may be, the returns earned by investors fall short of the aggregate market returns by the aggregate costs they incur, around $400 billion each year. Investors today focus on the illusory expectations market rather than the real market of intrinsic business value. While business values change only gradually, expectations change with incredible rapidity. The average turnover of U.S. stocks from mid-century through the 1970s was 20%, now it's 150%. This cannot enrich stockholders. But it is great for the croupiers of Wall Street. Individuals are so short-term oriented that cost doesn't seem to matter. After intermediation costs the system as a whole delivers negative alpha. The less choice we give investors the better. When we're talking about the needs of investors, do we mean the institutional investors or the last line beneficiaries of our pension plans and mutual funds? The ultimate shareholder, the client, dines at the bottom of the food chain. We have a new "agency society" that has completely supplanted the old ownership society. Today financial institutions own 68% of the shares of all our corporations. In 1950 that number was 8%. If these absentee owners and renters of stock don't give a damn about corporate governance, then who will? Conversely an index fund manager can't sell a name in their portfolio that's delivering a poor return. Their only avenue is to get into that company and make demands. There doesn't seem to be an arbiter without a vested interest in a private equity transaction. Active management still attracts assets because of the investment marketing system with its information asymmetry. Each investor believes that he can achieve above-average results. Because indexing is not interesting, it's been described like watching paint dry. The only exciting aspect is the returns at your statement at retirement age! The original index fund was the S&P 500 index fund. We moved away from sub-sector index funds like the Russell 2000 because of poor liquidity and noise that occurs each June where rebalancing is concentrated. There should be pressure for better indexing in sub-sectors. I recommend for a U.S. citizen, 10% industrialized international and 10% emerging markets. PE ratios don't matter much in the long run. Dividends matter and have contributed 4.5% to returns over the past century and 2% presently. Dividends will contribute less in the future, and we need to project lower returns. A Morgan Stanley study asked CFO's what are the future return on stocks; the consensus answered 6.11%. How can we continue to express long-term in nominal rather than real dollars? $1 compounded at a 13% nominal over 25 years gives $21. Using the real rate of 9.8% halves that and deducting a further 2.5% in mutual fund fees lowers it to $5.90 from $21. We're searching for this Holy Grail of superior returns for our clients. The work we do to serve clients seeks a comparative advantage for ourselves over other asset managers. But we don't spend much time thinking about a community advantage that serves all of our clients as a group. The more resources we pour in, by definition, the more our clients in the aggregate lose. Hedge fund of funds may be taking it one iteration too far. It takes Princeton Investment Co. 400 man hours to select a hedge fund manager and 75 man hours per year to monitor that hedge fund manager. According to the Burton Malkiel study, the average hedge fund provided 9.3%, so investors would have been better served by owning a low-cost, balanced mutual fund. And this 9.3% includes funds that used illegal market-timing strategies. I doubt that figure can be replicated again. If an index strategy for holding assets is not the best strategy for serving investor needs certainly the number of strategies that are worse is infinite! After Baron Von Clausewitz: the greatest enemy of a good plan is the dream of a perfect plan. john_c_bogle@vanguard.com

Jack Bogle

Please join me in expressing our gratitude to David Cattrell of Citigroup's Private Bank. David and his colleagues in the New England region are strong supporters of our mission. Citigroup believes strongly in investor education and we appreciate their continued support. david.cattrell@citigroup.com

Africa: The Last Frontier

Our topic, *Into Africa: The Last Frontier* is our second examination of the frontier markets. With the world's youngest population, terribly inefficient markets and tremendous natural resources, Africa seems like a risky place to make money. Walter Kansteiner runs the Africa practice at an influential investment bank. Before that he ran the State Department in Africa, setting US policy there. Paul Bate runs an emerging markets hedge fund with significant exposure to sub-Saharan Africa. Khaled Abdel Majeed left the legendary Blakeney Capital to start a hedge fund that focuses on North Africa. Heather James moderated today's symposium and is a native of South Africa. Heather reminded us that Africa should not be viewed as a continent but rather a group of countries, each with its own socio-economic personality. She also predicted that globalization will unlock Africa's riches and South Africa will lead the way. hjj@federal-street.com

Walter Kansteiner, The Scowcroft Group

Investors need to view Africa as 51 distinct markets. Many have opportunity and several are basket cases. Vice President Cheney once said the US has no national interests in Liberia. I corrected him. We import more oil from West Africa than we do from Saudi Arabia…20% of our crude supply. Africa has serious strategic interests. There are lots of natural resources. What about the infrastructure? Let's talk about the capital markets. There are 21 countries with a sovereign debt credit rating. Five years ago there were only 4 countries. Botswana has a higher rating than Japan. There are 13 stock exchanges. South Africa is the largest. Eight of the 13 practice the T+2 clearing standard. AIM in London is an important exchange for natural resource companies going public. This is just the beginning of functioning capital markets. What are the drivers? The continent is growing at 4 percent. Certain countries are growing at 8 percent. The basket cases bring the average down. The Congo is a fascinating case. It had negative population growth and GNP growth because of the war. The war is over, natural resources have been discovered and it will be the treasure trove of the continent. South Africa will be dwarfed by the Congo's mineral wealth. China and India are driving the demand. Five years ago the Chinese trading companies started buying the output from the copper and cobalt mines. Today they are buying the mines. Their thirst for these assets is growing. Today there are 30 thousand Chinese prisoners rebuilding the Benguelan railway in Angola to get access to the mineral wealth of the Congo. An important economy will emerge from this project. Doing deals in Africa is tricky. Investing in African stocks is like investing in private equity everywhere else. Investing in African private equity is like investing in venture capital everywhere else. Doing venture capital in Africa is crazy. Opportunity is authentic. Look at the brewery, cement, banking, and horticulture sectors. Intra-Africa trade is developing. Communications infrastructure is growing. India is outsourcing some of their call centers to Kenya. We're doing a cellular deal in Kenya: A Zimbabwean man builds the network. He has a falling out with his local partner who gets his brother-in-law to pull the license. Now he is forced to exit by selling to a telephone company from India. The moral is: know your partner, know your regulator, understand what you're buying, and stay on top of everything. Africa has terrific opportunities. Be careful! kansteiner@scowcroft.com

Left to right: Walter Kansteiner, Paul Bate, Khaled Abdel Majeed

Paul Bate, Matterhorn Investment Management LLP

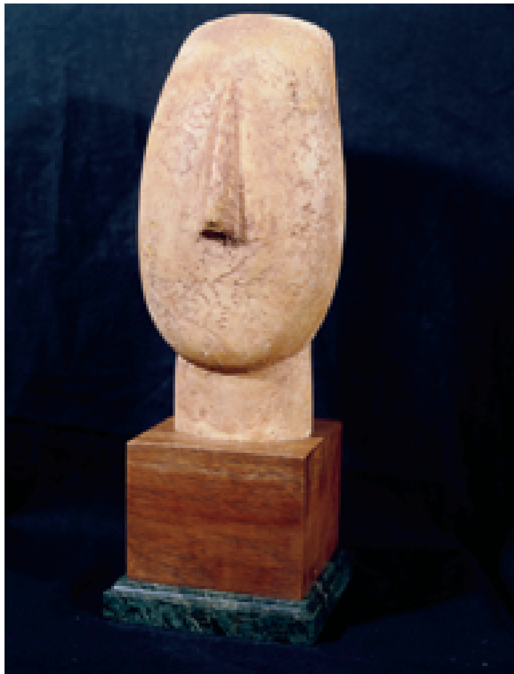
We invest in public markets from the bottom-up. We go where the big projects are unfolding. We look at real people who are putting valuable things into trucks, issuing invoices, getting paid, and generating cash flow. In 1980 I was in China surveying oil fields. China had the laziest workers. It was hopeless. China transformed itself from basket case to the hottest economy on the planet. Open your minds to the impossible. Today, Africa is a basket case. Tomorrow will be different. Five years ago we invested in a small Congo mining company. Today it's the largest cobalt producer in the world. Today five companies in Zambia and Congo produce 200 thousand tons of copper. By 2010 they will produce 850 thousand tons. The stock markets can't reward this kind of growth. It's so huge they can't price it in. The markets are only valuing today's production. This is a natural inefficiency. The banks are a great way to invest in the underlying growth. Hedging is difficult. Buying an African oil company can be hedged by shorting a British oil company. South Africa is the largest and most sophisticated market. Black Empowerment is a mistake. Teaching them how to build businesses would be better than handing over assets. Mozambique will benefit from South Africa's agricultural difficulties. Land is almost free in Mozambique. Our ethanol policy is a disaster. Corn is bad ethanol. Sugar is good ethanol. The former European colony countries in Africa are poised to produce sugar cane with lower costs than Brazil. First Quantum Minerals produces copper in some of the riskiest markets. But its market capitalization went from CAD 182 million in 2002 to CAD 4.8 billion because they are well run and took the risk. China's demand for commodities is insatiable. Most commodities have been under priced for 15 years. China is plowing aid into Africa…more than the World Bank. Paul Wolfowitz shouldn't coerce change; Jeff Sachs says we should just get the money in there. Africa's problems are its own. China doesn't have a monopoly on dealing with unsavory regimes. China is making heavy investments in oil in Nigeria, copper in Zambia, and rehabilitating the railroad in Angola. Robert Mugabe won't hold onto Zimbabwe forever. Investors should get ready for his departure. Exports to China are growing at 30 percent. This is a major decade-long, event. We've seen the end of the beginning. The opportunities are legion. paul@matterhorninvestment.com

Khaled Abdel Majeed, MENA Capital

Perception and reality in Africa are mismatched. My focus is on the Arab world in North Africa and the Middle East. The sub regions are the Maghreb, the Levant, Egypt, and the Gulf. The most interesting opportunities are in the Gulf (Cooperation Council - GCC), primarily from pricing issues. This region is undergoing enormous change. Demographics are driving the change. Half of the population is under 25. Unemployment is very high. Foreign investors are needed to create jobs. A useful legal system is needed. The Arab world is not monolithic. Morocco depends on rain. GDP grows at 7 percent when it rains, lower when it doesn't. At 20 times earnings, it's the most expensive market. Egypt, growing at 7 percent, is a reform story. The state started loosening its grip in the 1990s but lost momentum. In 2004, Mubarak's son revived privatization, liberalized the economy, and foreign direct investment boomed. Tunisia depends on tourism and agriculture. The GCC has $1.2 trillion in announced projects, a huge building boom. Its combined GDP is $600 billion. Qatar is the most interesting in the region and the second richest country in the world. Corn needs nitrogen based fertilizers to produce ethanol. Urea is the biggest component which is derived from natural gas. The largest producer of gas is Qatar and Saudi Arabia. Corn ethanol will substitute demand, not from the Middle East, but from oil to gas. In Qatar you were paying 35 times earnings for growth until the crash in 2006. Valuations in the GCC are low, averaging 12 times earnings. Growth prospects are good. An active approach is essential. There is a building boom in petrochemical infrastructure and smelters. Local retail investors dominate the stock markets. Shorting is difficult. Geopolitical or terrorist events don't affect them like foreign investors. But the market will plummet 25% if Iran is attacked by Israel or the US. There are other country specific risks. Succession of leadership is always a risk. But a new generation of leadership is embracing political and economic risk. Stay on top of the political developments and diversify your portfolio. kmajeed@menacap.com

Please join me in expressing our gratitude to RBS Greenwich Capital and Todd Brussel of their Structured Finance practice who generously provided the underwriting for today's symposium. RBS Greenwich Capital has a long history of quietly giving back to the community. As the newest member of our Underwriter's Council we selected Greenwich Capital for their good deeds and their work to support education for investors. We look forward to working more closely with Todd, his colleagues in the Structured Finance Group, and Greenwich Capital in general. todd.brussel@rbsgc.com

Continuing our series on art at the Bruce
Fakes and Forgeries: The Art of Deception
May 12, 2007 – September 9, 2007
Bruce Museum, Greenwich, CT



Cycladic Head
c. 2500 B.C.
Marble, 12X5 3/4 X 4 in.
Private Collection

Imitator of Piero Della Francesca (Italian, c. 1420-1492)
Portrait of a Woman
Tempura on panel, 12 3/8 X 10 in.
Museum of Fine Arts, Boston
Lucy Houghton Eaton Fund. Accession no. 40.237
Photograph © 2007 Museum of Fine Arts, Boston

Pablo Picasso (Spanish, 1881-1973)
Repas Frugal
1975 intaglio reproduction of original 1904 etching, 17 3/4 X 14 3/4 in. (image), 24 3/4 X 19 3/4 in. (paper)
Courtesy David Tunick Inc., New York

John Myatt (English, 1945-)
in the manner of Joan Miró (Spanish, 1893-1983)
Harlequiin Disturbs Sleeping Fish
Mixed media on paper, 20 X 16 in.
Courtesy John Myatt

Fall Symposia (morning sessions) and Founders Council (evening sessions)

As last minute changes do occur, our schedule can change at a moment's notice. Below is a tentative list of dates. Do not plan on being at the Museum without receiving an invitation. RSVP@GreenwichRoundtable.org

August 16

September 27

Founder's Council - October 2

October 18

November 15

The Greenwich Roundtable is A Not-for-Profit Organization. We rely on your contribution to accomplish our mission.

The Greenwich Roundtable

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