THE GREENWICH Roundtable Letter

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SUMMER-FALL 2005 • Volume 3, Issue 3

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First of the Best Practices Series

By Susan Benjamin

Best Practices in Hedge Fund Investing: Due Diligence for Equity Strategies, was published this spring. It is the first in a series of educational "Best Practices" reports the Greenwich Roundtable will be publishing for its members. It is also the first collaboration of its kind, between investors and managers.

Best Practices was made possible through the generosity of the Research Council. This group is comprised of managers whose expectation was that this publication would benefit a wide range of investors and become an educational tool for qualified private and institutional investors. The Roundtable's Education Committee members are investors with broad and diverse backgrounds. They wrote this guide to demystify a topic that has long been shrouded in myth and to help improve the level of education among those who wish to better understand the community of active hedge fund investors.

The reception to *Best Practices* has been gratifying. Favorable articles about the publication have appeared in *Financial Times, Pensions & Investments, Hedgeworld,* and *The Advocate and Greenwich Time.* Congressman Christopher Shays read an abstract of *Best Practices* on the floor of the U.S. House of Representatives with the following comments: "The Greenwich Roundtable is a not-for-profit organization, based in Greenwich, Connecticut with a mission to promote education in alternative investments. This thoroughly professional and thoughtful institution has produced a report entitled 'Best Practices in Hedge Fund Investing: Due Diligence for Equity Strategies,' that I hope will serve as an important reference for this body, for investors and for others interested in our capital markets…It seems to me this is a very important document and would recommend it to any of my colleagues with an interest or concern about the industry to review it."

Greenwich Roundtable members have access to *Best Practices* through their membership. Other interested parties may purchase the report by contacting the Greenwich Roundtable through our website *www.greenwichroundtable.org*.

BAM! The GR Website Kicks it up a Notch

By Carrie Staub

You asked and we acted. The Search Engine feature on the Greenwich Roundtable is not only working again but it is better than ever. Want to know when the Connecticut Attorney General spoke at the Roundtable and what he said? Type in "attorney general" and you will get his bio, speaker transcript, a description of the symposia, and the link to the archived page where you can listen to him talk about his views on the regulation of private funds. The GR search engine is an important gateway to the largest collection of alternative strategy discussions available … anywhere.

Visit the GR website and you will also see that we are in the process of providing you more material than ever. In addition to information on the 256 speakers and 91 symposia, browse the new Best Practices page, where you will find the recently published abstract (for non-members) and full text (for members) of *Best Practices: Due Diligence for Equity Strategies*. Peruse our new Quarterly page where you can find PDF versions of that publication. Most importantly - keep stopping by because we are adding new materials and features on the website all the time for the benefit of the Greenwich Roundtable community.

Why not make us your home page? After all, it's *your* website.

www.greenwichroundtable.org

Happenings

Christian Zugel

Francois de Visscher, Rian Dartnell

Leon Gould, Lloyd Hascoe, Michael Castine

Frank Wisner

Mark Pearl, Hedi Lankeit

Richard Robb

The Outlook for Investing in Latin America

Our session titled *The Outlook on Investing in Latin America* was held as a continuation to a discussion we began in April 1997. Ernesto Zedillo is the architect of Mexico's recent economic and social successes. As a former head of state, he is a man of great accomplishment and humility. Today he offered a mixed report on the region. Peter Gruber is one of the world's most experienced (and courageous) emerging markets investors. As a pioneer in Latin America investing, he still maintains his optimism on the region. Rian Dartnell continues to moderate his series on the emerging markets. Today, he briefly returned to his roots as a Latin American portfolio manager by framing today's discussion with a summary of the region's wild economic volatility. *rdartnell@graniteassociates.com*

ERNESTO ZEDILLO, Center for Study of Globalization at Yale University,
ernesto.zedillo@yale.edu

What can we say about Latin America today? Long term, there have been significant improvements. In the eighties, the economy saw hyperinflation and overwhelming governmental presence. These conditions triggered many explosive financial crises. Fundamentals were always weak and uncertainty prevailed. Today, significant reforms of the late nineties have eliminated these episodes. Last year the region grew at 6% after years of stagnant economic growth. (Venezuela grew at 17% due to the rise in oil.) Inflation is still higher than our trading partners but it continues to fall. Our economic policies are much sounder and flexible exchange rates are helping. Foreign investment is growing. Lending has recovered significantly. The vital signs are positive. What is the bad news? We are not there yet! Our economies continue to be vulnerable. We still do not have the structural capacity to withstand a slowdown in the global economy. We are vulnerable to interest rate increases. Still, we have not completed our homework after all these years of adjustments and reform. The people complain about "reform fatigue." They are questioning the wisdom of our reforms. The debate centers on whether we should return to the old ways of authoritarianism. I don't expect a revolutionary enlightenment. But we will begin to see a process of gradual realization and then reforms will continue. Venezuela will be an exotic exception as long as the price of oil stays high. Going forward, there will be a tipping point where critical mass in structural capacity is achieved. I'm pessimistic about the medium term. We will see a widening gap between other emerging markets. I'm optimistic about the long term. Latin America is a significant region. Last year, the GDP of Latin America was greater than China. Longer term, Latin America will grow very fast. What is needed? Economists agree that fiscal consolidation and other specific policies will help to get us there. Why don't we enact them? Politicians haven't agreed yet. The problem is that Latin America has very weak governments. Though the leaders have significant personal power they lack political willpower. My job was to reduce my presence over the economy (and I did). Governments still do not have the ability to enforce the rule of law and the rule of fiscal control. Once they do, gradually, we will arrive at the tipping point. Then the development of Latin America will be spectacular.

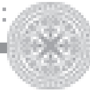
PETER GRUBER, Globalvest Management Company,
peter@globalvest.com

Latin American was primitive in the sixties. Enormous class differences divided the populations. Governments acted in their self-interest rather than thinking as a group. These situations have changed…radically. Things have changed due to communications and the rapid dissemination of information. Thanks to the internet, governments cannot control the flow of information. Governments must appeal to the rational needs of their citizens. In that process, the individual will be able to contribute to the greater good. Once governments allow greater freedoms to their people, Latin America will grow faster. Latin America has a huge population base and an enormous geography. Technology is raising the standard of living for the people. Free markets are developing quite separately from the will of the politicians. Politicians are not in tune with the will of the people who will break rules to raise their standard of living. People have the right to their own self-interest. Corruption will diminish once people believe in this right. Latin America has no military threats. It enjoys the protection of the US umbrella and does not spend a dime on defense. Latin entrepreneurs and investors are investing in their own region rather than the US. Free markets create volatilities tied to the economic cycle. These cycles are natural and shouldn't be confused with poor government. Like the Samba, it will take three steps forward and two steps back. Latin America is on the up swing. But the easy money has been made. Take advantage of any pull backs. Short term, we are cautious. The stock markets are at historical highs and overdue for a correction. The currency markets will pull back after recent strong performance. Uncertainty exists: global growth is unclear; six presidential elections are looming; and valuations are cheap compared to the US but high by local standards. Like the US, Mexico should be underweighted. Chile & Peru are commodity related economies where Chile has high valuations. Copper producer, Madeco, is a restructuring play. Peru has a thin stock market where liquidity is an issue. Argentina and Brazil are rating plays and should be overweighed. The Argentinean bank, Bansud, will benefit. Brazil has a competitive steel industry that it didn't have fifty years ago.

Please join me in expressing our gratitude to David Cattrell and The Citigroup Private Bank who provided the generous grant that made this symposium possible. More specifically, we are enormously grateful to his colleague, Clark Winter, who was instrumental in bringing President Zedillo, an accomplished former head of state, to share his point of view.
clark.winter@citigroup.com *david.cattrell@citigroup.com*

As always, please send me your comments and suggestions.
steve@greenwichroundtable.org

Clark Winter, Ernesto Zedillo



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The Outlook on Structured Credit and Asset-Backed Strategies

Our session titled *The Outlook on Structured Credit and Asset-Backed Strategies* was held as a continuation of a discussion we first began in May of 1998 when several investment bankers sang the virtues of the equity tranche. Several years later, after those equity tranches evaporated, these markets have ballooned and some real price inefficiencies have emerged. There seem to be some solid opportunities in the midst of sectors long since abandoned or orphaned. Peter Rappoport is the preeminent head of credit research for a super bulge bracket issuer. Richard Robb is a savvy hedge fund manager who specializes in the European structured credit markets. Richard is also a professor at Columbia University's School of International Affairs where he has referred several first-rate interns to the GR staff. Christian Zugel founded a successful hedge fund that focuses on distressed asset-backed securities. John Rogers, Ivy Asset's highly articulate head of private equity and structured credit, moderated today's panel. *jrogers@ivyasset.com*

PETER RAPPOPORT, JP Morgan Chase, *rappoport_p@jpmorgan.com*
I focus on CDOs and the securitization of loan portfolios. We repackage existing syndicated loans. I'm less impressed with the growth of the CDO market than I am with the underlying values. To illustrate my point, imagine a balance sheet. A corporation buys assets and issues liabilities. An asset manager is working in between maximizing the value of the asset portfolio for the (junior) equity investors while keeping the debt holders happy. People get excited about the liability side of the balance sheet. The CDO industry carves up liabilities into senior, mezzanine and equity tranches. Structured credit involves the creation of an accounting framework for determining how tranches get paid from the cash flow thrown off from assets and liabilities. The rating agencies apply a formula to rate these structured credit deals. Investment banks then create a monster spread-sheet called the rating model because the deal is priced according to its rating. The deal is not priced on its underlying collateral, its true risk or its asset manager. Rating models are not built to reflect true risk and return. The liability side is just accounting. The challenge (and opportunity) lies in applying a risk-reward framework to liabilities. Value will be hard to create if the assets aren't cheap. Assets must pay some amount that covers their default risk. All covenants that protect debt holders are triggered off the principal value of the assets. If defaults begin to accumulate, the deal falls apart. Cash flows are diverted from equity holders to restore the debt holders. The liabilities need to be structured to recognize the possible (worse case) path of defaults. High "headline" yields are irrelevant. Single B bonds pay exciting sounding spreads. But they don't pay enough to credibly cover the very real default risk. They are attractive to the yield chasers who advertise their fund simply on its yield. Another example was 1998 when everybody had stars in their eyes. They levered those high yield CDOs with tiny equity tranches and advertised high equity returns based on low defaults. When defaults began piling up, the equity tranche was not enough to protect the mezzanine and senior holders. Some investment banks are still pitching these deals based on the best case for defaults. More attention needs to be paid to the worst case. These liabilities are bonds on steroids. Their optionality and their complexity reduces their predictability.

CHRISTIAN ZUGEL, Zais Group LLC, *christian.zugel@zaisgroup.com*
Our entire focus in on structured credit and my gray hair comes from the period from 1998 to 2002. We model our 1300 transactions to build water-fall analyses to estimate defaults. We've returned $1 billion to investors. We are one of the few firms who can demonstrate how risky the asset class is by showing realized returns and our average return has been above 8 percent. Even during the perfect credit storm of 2002, we made 6 percent. The structured credit universe is large. Interesting investments have shrunk a lot. In 2003, there were 19 offerings where 15 looked interesting. Today, only 1 in 20 look interesting. Selectively, CLO equity tranches look interesting. Good managers have very little capacity. Bad managers have a lot of capacity. Some problems could be waiting in loan market because of high "headline" yields. A lot of second lien loans (high yield bonds in disguise) have been issued, single B rated where the default risk is very high. Synthetic or derivative CDO tranches are interesting. After LTCM blew up, some players took "tranche index trades" where opportunities have emerged. We believe playing between the cash and derivative markets offers opportunity. Cash players talk about defaults, severity of loss and collateral quality. Derivative players talk about correlations, risk neutral pricing and attachment-detachment points. Yet their markets share the same risk. Either it goes belly-up or it doesn't. These differences in outlook and language must converge. We see opportunity where one player completely misjudges the risk. There are also complex opportunities in the secondary markets especially in the US home equity market. Why do these opportunities exist? There are very few people who can take the time to do the work, do the analysis and to model the waterfalls. It can be done but there are still only a few who actually do it. Another factor is the many players with different agenda. For example, ratings-based buyers must sell if a credit agency downgrades. In 2005, synthetic based buyers programmed the models wrong…opportunity! In sum, there are many opportunities…more than in debt in equity. You've got to do your homework. You've got to be a long-term player and you've got to be patient to survive periods of no liquidity. A detailed understanding of the collateral structures, the ratings agency methods and the models are essential. Investing in strategies with 5 times leverage and monthly liquidity is a fool's game. Look for 8 – 12 percent returns, no more. Look for managers who take incentive fees at the back end.

RICHARD ROBB, Christofferson, Robb & Company, Inc., *richard@christoffersonrobb.com*
The European ABS market in 1998 was EU25 billion. In 2004, it was EU 250 billion. It is an important source of financing for business and consumers. Investment bankers did not push something this big on us without creating some economic value. European opportunities lie in loans, mortgages, and credit cards. In the case of collateralized loan obligations, the equity tranches are interesting where there is a specialty asset manager purchasing, analyzing and negotiating these subordinate tranches. Opportunity also exists in allowing banks to shed their business cycle risk. Banks will securitize large pools of their loans. The bank performs the credit analysis and still absorbs the first losses. But the generalized credit risk of the world or their country is transferred to investors who are more suited to taking that risk through securitization. The largest corporate defaults of 2001-2002 did not produce a financial crisis because the securitization and the credit derivative markets shed the risk and banks could continue to function as intermediaries. In the CDO market, the obvious opportunity was with the distressed sellers in 2002. Hedge funds can manage and analyze the complexity. Funds are also making these markets more efficient. Hedge funds can respond to the investment banks motto…'if it's such a good deal, why should we show it to you?' with "why do we need all these middlemen?" Hedge funds can negotiate directly and privately with an issuer of a loan pool. We can avoid the costs of entering the public securities markets and split the proceeds with the issuer. In Europe, we are at the beginning of the efficiencies of securitization. In Italy, a 50-70% down payment is still needed to buy a home. In Germany, home ownership is still half the US average and mortgage markets don't function. Some day they will function more efficiently through mortgage-backed securities. Lots of value will be created and money will be made. Other opportunities exist in Rules VIS II and IS39 regulations which forces mandated selling. Mexico reformed its bankruptcy laws, created a mortgage backed securities market and opportunity exists. India declared that securitization is its most important priority but quickly imposed a stamp tax that blocked foreign buyers.

Please join me in expressing our gratitude to DPM Mellon and Bob Aaron. DPM Mellon has generously sponsored today's symposium. As you know, Bob Aaron has underwritten most of our symposiums on market structure and those that deal with complex strategies. *Aaron.R@dpmmellon.com*

UNDERWRITTEN BY
CommonFund Capital

India: Bureaucratic Elephant or Bengal Tiger?

Our session titled *India: Bureaucratic Elephant or Bengal Tiger?* was held as we examined this 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 Wisner is the highly regarded career diplomat who also guides external affairs for one of the oldest US corporations in Asia. Ashish Dhawan is a successful venture capitalist operating in India, who also has a strong background from Goldman Sachs. Samir Arora is a gifted stock picker and one of the only seasoned hedge fund managers in the India markets. Reviewing 500 years of India's history in five minutes, Rian Dartnell thoughtfully guided the panel in his fourth of five symposiums on the emerging markets. rdartnell@granitelp.com

FRANK WISNER, AIG, Inc., *Frank.Wisner@AIG.com*

Prime Minister Singh addressed a rare joint session of the US Congress on l8 July 2005. This marks a defining moment in history, a turning point, in the relationship of two great nations with such a long and complicated past. These two great superpowers, one established and one emerging, now view each other differently with many shared values. The most striking feature is the remarkable broad based growth of the Indian economy (GDP in excess of 7 percent). Their service sector is world-renowned. Its manufacturing sector is globally competitive. And its rain-dependent agricultural sector remains volatile. Capital markets have perked up and interest rates have dropped dramatically. India has the highest foreign exchange reserves in its history. There is a steady but uneven retreat of government from influencing the economy. The private sector is asserting itself. Driven by domestic consumption, India is on the road to an open economy. The huge untapped Indian market will continue to power economic growth. With rising incomes, a credit boom, positive demographics, and a growing service sector, India can finally care for her own people. But India can do much more. Many factors can drag India back. She is capable of 8-9 percent growth but it will not happen. India's fiscal deficit is a big problem. Rising public debt, a declining savings rate and deteriorating local finances all portray a troubling fiscal picture. India's huge public sector, its large workforce and its low tax revenue base all conspire to, unfortunately, starve government investment in the country's infrastructure. Indian government is unnecessarily complex. For example, the dynamics between state and national (Center-State) governments prevent foreign investments from reaching its electric utility sector. Corruption is still common. Labor laws make hiring and firing difficult. Majority ownership by foreign corporations is prohibited in the insurance, banking, media, and retailing sectors as well as the pension markets. India is still a land of high tariffs. Investors, beware of the tax authorities. They are tough, whimsical and unpredictable. My view is that India is on the move. She won't be stopped. India will be a great world economic power, in the top 3, over the next 10 years! Before this week, the US and India were at nuclear odds. Today the stage has been set to work together. There is much to be done. Prime Minister Singh is a gifted intellect and reformer but (respectfully) does not have the political skill to deliver.

ASHISH DHAWAN, ChrysCapital, *ashish@chryscapital.com*

India's GDP growth is rapidly accelerating. When India opened in 1991, the Bombay Club was formed to fight reform and protect Indian companies from foreign invaders. In 1996 these industrialists realized that globalization arrived and India could no longer stay isolated. Indian companies hunkered down and became more efficient. There has been a sea change in the mindset of the entrepreneur. Today, Indian companies believe they can compete with any company in the world. Indian entrepreneurs are thinking big, building multi-billion dollar companies. Indian entrepreneurs now recognize that good corporate governance builds wealth. They realize that building market cap is much better than stripping dividends from minority shareholders. Also, consumer behavior has changed. Consumers have a choice now. Before you either waited 1 year for a telephone line or you bribed someone. Today there are 10 telephone services available. For investors, India has a broad and deep market. India excels in labor-intensive businesses such as IT services, banking, outsourcing, and pharmaceuticals. None are capital-intensive businesses and they spit out cash. The private equity asset class is exploding and has gained broad acceptance. Almost USD 2 billion will be invested this year. M&A activity is very low. Eighty percent of all deals are for growth financing. IPOs are the primary exit strategy. India has many risks. Valuations have risen dramatically. Too much exuberance is the real issue. They're opening the door to foreign direct investments slowly…you (investors) will have an early mover's advantage. The outlook is bullish on macroeconomic growth. Demographics work in India's favor. Investing in India is a 20-30 year story. Be cautious and take your time.

SAMIR ARORA, Helios Capital, *samir_arora@helios.com.sg*

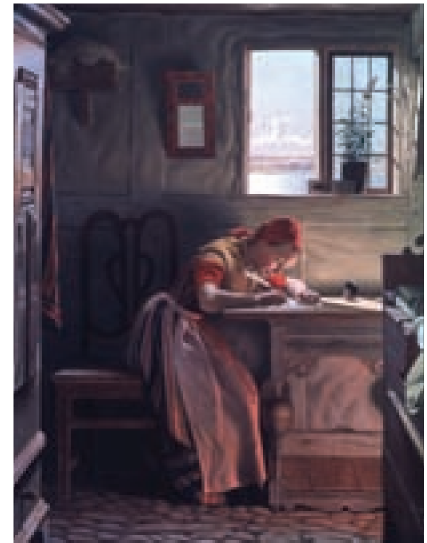
I've always felt India would become the largest emerging market…primarily because all other markets will have become developed. Only recently has our top down view become bullish. Before that our view was bearish…but overweight. We were never happy with the slow pace of Liberalization but there were always good companies to buy. Today many industries are being opened to domestic and foreign investors through the cumulative effect of many small reforms. Like the book, *Tipping Point*, India is benefiting from many small accomplishments, rather than big events. Going slowly has benefited us (investors) because we've been able to participate. Top down, you can build any story you wish; the success of its IT sector, as an outsourcing powerhouse, or its inexhaustible pool of English-speaking graduates. But 25 percent of India's population lives below the poverty line and there are 350 million illiterate adults. Can we generate 80 million jobs (for young people) in the next 5 years? India's history of job creation has not been good. The real story of India is a bottom's up story. Transformation is happening in many industries. It's easy to understand. Bottom's up, the stock market started in 1875. These companies operated in the private sector where government prevented them from making a profit. After Liberalization, companies were free to hire and fire, to merge or expand, or to price to the market. Some thrived and some folded. No one knew which ones would be successful. Then several government-controlled industries were slowly privatized and floated publicly although the management or the structure did not change. Paying no entry premium, new private market entrants become fierce competitors who then killed the old bloated government entity over time. Investors made 50X and 100X in some cases. It was easy to achieve 10-20X ROR. Growth came in three ways; through restructuring, through the expense of old government entities, and through better market penetration. Today, many sectors have yet to be opened and the government still controls the industry. This is a huge opportunity. Our mantra is to compete with the Indian government. The biggest risk is that no one knows what the next risk will be. In the last 10 years; we had a plague in 1994, interest rates rose by 6 percent and stocks dropped 35% in 1995, one government lasted 14 days in 1996; the US sanctioned India for its nuclear test in 1998, we had a war with Pakistan in 1999, and we had our worst drought since 1945 in 2002. Above all, the opportunities outweigh the risks.

The Commonfund has not only provided the generous grant for a session but the Commonfund Institute also continues to perform original research with insights on asset allocation, best practices and funding levels that benefits endowments and foundations throughout the US.
jgriswol@cfund.org

The Greenwich Roundtable

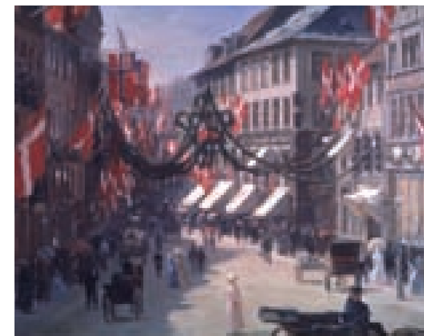
presents
The John Loeb, Jr. Collection
of Danish Art

From time to time the Roundtable Newsletter will present items of interest from the activities of our members. We are pleased to report that we introduced John Loeb, Jr., a Roundtable member, to Peter Sutton, Executive Director of the Bruce Museum. Their meeting resulted in a dazzling display of Danish art that Mr. Loeb collected while serving as US Ambassador to Denmark during the Reagan administration.



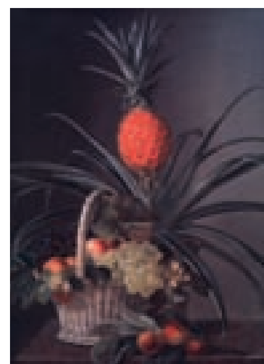
Christen Dalsgaard (1824-1907)
Young Girl Writing (*Ung pige, der skriver*), 1871
Oil on canvas, 25 x 18 3/4 in.

Joel Ballin (1822-1885)
Study of a Model. Young Girl Undressing
(*Modelstudie. En ung pige klœder sig af*), 1844
Oil on canvas, 46 x 36 1/4 in.



Otto Bache (1839-1927)
Flag Day in Copenhagen on a Summer Day, in Vimmelskaftet
(*Der flages, sommerdag I Vimmelskaftet*), after 1892
Oil on canvas, 17 2/3 x 22 in.

Paul Fischer (1860-1934)
Harriet Skiing (*Harriet på ski*), early 20th century
Oil on panel, 11 3/4 x 7 3/4 in.



J.L. Jensen (1800-1856)
Still Life of Fruits with Pineapple
(*Frugtsykke, opstilling med ananas, blå og grønne druer i en kurv og ferskener på en stenkarm*), 1833
Oil on canvas, 21 1/2 x 21 1/2 in.

Peder Severin Krøyer (1851-1909)
Self-Portrait, Sitting by Easel at Skagen Beach
(*Selvportrœt, siddende ved staffeliet på Skagens strand*), 1902
Oil on panel, 21 1/4 x 17 3/4 in.

Fall-Winter 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 first receiving an invitation and a confirmation.
RSVP@GreenwichRoundtable.org

October 20, 2005

November 17, 2005

December 15, 2005

January 19, 2006

February 16, 2006

Founders Council
October 4, 2005

Founders Council
December 6, 2005

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The Greenwich Roundtable

Box 4019, Greenwich CT 06831

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My enclosed check is made payable to "The Greenwich Roundtable, Inc."

Name ____________________ Phone ____________________

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