swissHEDGE

1st Quarter 2007

A Review on Developments in the Hedge Fund Market

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Hedge Funds in Latin America

Contents

Editorial I Stephan Fritz I Harcourt AG	3
Hedge Fund Industry Commentary I Stephen Williams I Harcourt AG	4
Strategy Review I Neil Paragiri I Harcourt AG	12
Investors View I Christopher Palmer I Gartmore UK	18
News behind the News I Matthias Knab I Opalesque	24
Special Feature I Hedge Funds in Eastern Europe I Christoph Kampitsch, Mark Cachia, Sonja Remetic I Erste Bank	30
swissHEDGE Roundtable 1st Quarter 2007	36
Events 2007 I Harcourt Events I Upcoming Conferences	43

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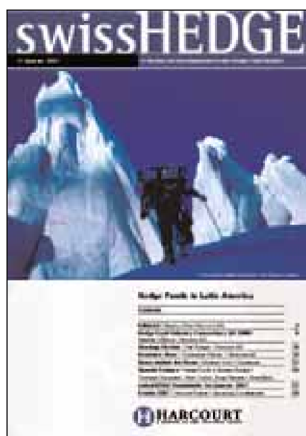

Cover

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Expanding the frontiers of finance

Stephan Fritz | Harcourt AG

Hedge Funds represent the leading edge of investment techniques. They perform the important role of discovering and exploiting the investment potential of nearly all kinds of markets. Their focus may be regional or global, their respective strategies range from specialised niche areas to global market investments. Supported by recent economic and political developments, hedge funds now push the regional frontiers of their investment universe.

During the past few years, the political environments in many parts of the Emerging Markets have stabilized significantly. Fuelled by maturing local capital markets, sophisticated technology, and the growing demand in natural resources, this has proven to be an excellent breeding ground for hedge funds. A point in case is Asia, where the number of Asian hedge fund mangers has tripled in the past four years. Less well known but equally interesting is the fact that similar growth rates apply to the developing Latin American hedge fund industry.
It is not only the number of managers that has increased significantly in the emerging regions. The quality of managers, their set up and education has allowed them to constantly close the gap to their more established peers in the US and Europe. Despite the large recent inflows of capital, the new but healthy competition ensured continued top performance for hedge funds focussing on the Emerging Markets. By most counts, Asian hedge fund indices show significant outperformance versus European and US Indices. The same goes for Latin American hedge fund benchmarks, displaying a stellar performance during the last few years.
These trends are set to steadily continue into the near future. The recently published 2006 Alternative Investment Survey by Deutsche Bank indicates that investors are set to increase the allocations to China, Asia and Latin America most significantly. We too believe that these markets promise to be the most dynamic drivers of growth for the hedge fund industry in 2007.
The Latin American hedge fund industry has grown by more the 50% over the past two years. Currently there are about 300 hedge funds focused on the region that manage approximately USD40b. Financial institutions recognize the potential of Latin America as well. For example, Credit Suisse took a majority stake in local Hedging-Griffo in December 2006, one of the leading investment banks and hedge fund managers of the region. Also politically, Latin America is much more likely to play a bigger role in world events going forward.
As an institutional funds of funds with a primary responsibility to create performance, Harcourt has been investing significant time and resources on researching the area. Please find our conclusions in the "strategy review" part of the magazine.
On another note, Harcourt will be celebrating its 10 year anniversary later this year. We are proud to look back on a decade of alternative investment excellence, and for having played a role in this exciting industry. We are planning a major event this summer, and intend to publish a commemorative issue of swissHEDGE shortly.

Hedge fund industry commentary Q4 2006

Stephen Williams & Research Team I Harcourt AG

General market environment in Q4 2006

A relatively uneventful fourth quarter provided a stable environment. Equity markets surged ahead as benevolent circumstances allowed them to maintain momentum and follow the path of least resistance upwards. The oil price was broadly stable and fixed income markets were range-bound, allowing fundamentals to come to the fore. Fears for the US economy and wider political instability were largely pushed to the background as the quarter offered good returns.

The S&P 500 gained 6.29% during the quarter. Continuing moderate growth and a benign inflationary outlook proved a winning situation for equities. An increased appetite for risk pushed Energy and Materials into the top spot for sector performance after a poor third quarter. Healthcare trailed home last, hit by the Democratic victory in the US midterm elections. The same holds true for the full year 2006, demonstrating the continuing allure of the natural resource sector, though performance was very concentrated at the beginning and end of the year, respectively. Small caps outperformed large caps in another reversal from the previous quarter as the Russell 2000 increased a handy +8.55%.

In Europe, the MSCI Europe rose +6.74%. Healthcare was also an underperformer on the Old Continent while

Industrials and Telco's powered ahead. The strong showing of energy was reflected less in the specific sector, but more in national markets where the energy-heavy Norwegian market was a top performer at +19.82% for the OBX. Japanese markets finished a poor year with a mixed quarter. Small cap underperformance continued as positive performance from the Nikkei and Topix contrasted with further drops in the TSE2 (-0.87%) and the Mothers index (-8.57%). Emerging markets delivered the strongest growth globally with China as the best performer followed by major markets in Latin America as well as Russia.

The main fixed income markets saw a lot of range-bound trading in the last quarter of 2006. Short-term rallies were followed by light sell-offs, leaving rates relatively unchanged. In the US, the market was pricing in rate hikes for Q2 of 2007, but as the quarter progressed it became clear that the Fed has no inclination to cut rates any time soon. Inflationary pressures remain too high to give the Fed room to manoeuvre and as the market came to realize this, the Eurodollar contracts started to reflect the Fed keeping rates on hold for the foreseeable future.

The 10y Treasury reached a yield of 4.83% in October, and then rallied back to 4.42%. It ended the quarter at 4.70% as a consequence of strong economic data coming out. The market continues to be torn between soft housing data, strong employment figures and lingering inflation pressures and we expect this to continue into the first quarter. Europe saw a similar pattern with the 10y rate touching a low of 3.67% in early December, but ending the year at 3.94% after a strong sell-off. The ECB hiked rates by 25 bps during the quarter, putting the short-term lending rate at 3.75% with the expectation of one or two more rate hikes to come in 2007. The European curve has flattened markedly during the last 12 months with the difference between short-term and long-term rates being only marginally positive. The growth picture in Japan fizzled in the latter half of 2006 as a raft of disappointing data came out, giving the Bank of Japan no room to hike rates. In our view, only a pickup in domestic demand will allow the BoJ to make its next move. Volatility remains at multi-year lows in both industrial countries and emerging markets, which is largely credited to the stable macroeconomic environment, significant developments in the financial markets, and improvements in monetary policy across the globe.

Crude oil traded within a range for much of the period and finished slightly down at -3% over the quarter. Natural gas rode up on a weather-driven rally through November but then gave back much of the gains in December to finish +12%. Base metals saw mixed performance again; the LME index was virtually flat at -0.5% but the smaller metals of Zinc and Nickel were again star performers at +27% and +13.5% respectively during the quarter. Commodity index performance reflected the differences in their composition; the energy-heavy Goldman Sachs Commodity Index was -5.7% while the broader DJ-AIG was +4.1%.

In currency markets, the USD came under some pressure and succumbed in November, losing ground against other major currencies, though this reversed somewhat in the final month of the year. The EUR/USD rate ranged between 1.25 and 1.33, while the USD/JPY cross ranged between 114.90 and 119.78 during the quarter.

Performance of hedge funds in Q4 2006

In a generally bullish quarter, all strategies with the exception of short selling were positive. Equity based strategies were particularly strong, with emerging markets being the stand-out performer. Sector specialists came home second, closely followed by event driven and merger arbitrage funds. Macro and CTA funds were negative in the third quarter but turned things around to more than compensate during a strong fourth quarter. The FTSE Hedge investable index was positive (+2.66%), compared to the non-investable HFR Fund of Funds index (+5.33%) and the

Table 1 | Hedge Fund returns Q4 2006

Hedge Fund Strategy	Ret Q4 2006
FTSEhx	**2.66%**
HFR Funds of Funds	**5.33%**
HFR Hedge Funds	**5.20%**
CSFB/Tremont Hedge Funds	**3.82%**
Convertible arbitrage	2.77%
Emerging markets	11.42%
High yield	3.01%
MBS arbitrage	2.05%
Sector specialists	6.01%
Statistical arbitrage	3.96%
Fixed income arbitrage	1.61%
Relative value arbitrage	4.49%
Distressed securities	4.97%
Merger arbitrage	5.65%
Event driven	5.90%
Long/short equity	5.38%
Market neutral equity	2.53%
Macro	5.47%
CTAs	3.12%
Short-selling	-1.75%
MSCI World	**8.02%**
JPM Global Bonds	**1.59%**

Source: FTSE; HFR; CSFB; Barclay Trading Group Ltd.; MSCI; JP Morgan

non-investable HFR Hedge Funds index (+5.2%).

Directional Equity Strategies. Directional Equity managers overall continue to have a large net long bias and as such much of the returns was driven by performance of underlying markets. Long/Short US managers delivered about +5% for the quarter on average. It is noteworthy that US managers did well every month of the quarter, even in December when small cap stocks underperformed the S&P. Most of those who fared better had exposure to small cap stocks, Energy, Materials and Consumer Discretionary. Long/Short European managers also did very well for the quarter, adding just over 5% and capturing most of the MSCI Europe performance. Many managers would have benefited from exposures to small caps and oil service companies. It is precisely these exposures that enabled European hedge funds to deliver positive performance even in November when the MSCI Europe ended in negative territory. Japanese managers had a more difficult environment once again than their overseas counterparts, delivering barely positive number of +0.72% for the quarter. While the broader indices were positive, the small cap sectors to which most these managers have been quite exposed for a while, were negative for yet another quarter. Hedge funds in the emerging market space delivered stellar performance overall for the quarter. All of the regional funds did well, particularly those exposed to Latin America. On a country level, Chinese managers reaped the biggest rewards as the underlying markets posted remarkably high returns. At the bottom end of the league table were funds with high exposures to Korea and Thailand.

Relative Value Equity Strategies. Merger arbitrage and event driven hedge funds had a very strong quarter. The HFRI Merger Arbitrage Index gained 5.65%. Merger volumes were very strong in the fourth quarter. The largest transaction was the consolidation in the Norwegian oil service sector between Statoil and Norsk Hydro. Due to the complexity of the deal, the spread trades at an attractive level. Private equity firms continued to be very active, and are involved in the largest transactions, such as Equity Office Property Trust, Harrah's Entertainment or Clear Channel Communication. Several transactions received hostile bids from strategic buyers, benefiting positions by hedge funds in target companies. Looking at different regions, while the US has seen higher volumes in the quarter, most hedge funds generated a vast majority of their profits in European exposure, as bidding wars such as MAN/Scania/VW or around Endesa continued to be profitable. There were only limited opportunities in risk arbitrage in the Asian-Pacific region, with the exception of Australia, where the market for corporate control was very strong. The IPO flow continued in Asia, especially China, where ICBC raised USD22b in October. Amongst the few investments that cost event driven funds money were EMI, that again rejected a private equity bid; and Arcelor Brazil, where an enforced minority squeeze out by the parent company was offered at disappointing terms.

Convertibles arbitrage funds had another profitable quarter. The index increased by 2.77%. Implied convertible volatilities declined over the quarter, both in the US and in Europe. Realized short-term volatility also decreased in December as the holiday period began. The credit environment was favourable, as credit spreads continued to contract, albeit at a slower pace than in previous quarters. Through an implied volatility lens, the convertible market continues to have only limited attraction as pricing remains at fair values. Anecdotally, convertible funds have taken more equity market risk and benefited from the strong equity markets. Another important driver was new issuance in the US with USD25b aggregated volume and attractive pricing of certain bonds, especially the USD 4.95b Ford issue. The primary market became also more active in Asia, but Europe and Japan were lacking.

Quantitative managers had a positive quarter. The HFRI Equity Market Neutral Index gained 2.53%. Valuation and momentum were the most profitable factors of longer-term models. Residual returns from takeover activity influenced funds differently, as some managers were able to recoup some of the losses that were generated by holding short

positions in companies subject to merger bids from earlier quarters. Short-term traders had a very strong quarter as the HFRI Statistical Arbitrage Index gained 3.96%. Both technical signals as well as medium term factors were strong contributors.

Directional Fixed Income Strategies. Long/Short Credit managers performed well during the fourth quarter (+3.01%) as spreads remained range bound. An unusual amount of high yield paper came to the market, with November alone counting for USD32b of issuance, 50% of which was related to LBO activity. The market remained unfazed in view of all this supply and absorbed it readily. CDO structures were a main driver behind this demand with one good deal pricing another. Credit funds were able to take advantage of attractive primary deal spreads and also benefited from several themes that had been running for a while. These were airline, auto and energy exposures. In particular Northwest, Ford, GM and GMAC were great performers during the quarter.

Distressed managers had a phenomenal run in Q4 (+4.97%) as a number of legacy distressed situations such as Enron and Adelphia paid out. Other names that contributed were Dura Automotive, Delphi, Federal Mogul and Delta. Recovery rates remain at all times high across the capital structure. However, the opportunity set going forward is limited as low interest rates, a robust economy and strong corporate balance sheets lead to low default expectations for the next 3 quarters.

In Emerging Markets, investor sentiment was running high going into the fourth quarter. This proved beneficial, as

managers took advantage of movements in rates in Mexico and Brazil, rallying FX markets, tightening credit spreads and higher equity markets, in particular in Asia. Thailand was one of the main exceptions as the Central Bank tried to impose capital controls.

Asset based lending continues to deliver steady returns. Although returns in certain areas such as insurance have declined due to increasing competition, the market is expected to grow further in terms of strategies and geographies covered.

Relative Value Fixed Income Strategies. Fixed Income Arbitrage managers posted positive performance during the quarter (+1.61%). Large contributions came from curve positions and directional positions in Europe and the UK and to a lesser extent the US. Opportunities in Japanese rates were muted for the quarter. Although not spectacular, returns of Fixed Income Arbitrage managers in 2006 was in line with past performance, posting a +7.29% gain.

MBS Arbitrage managers put in a solid quarter (+2.05%) as OAS levels remain near recent lows on lower agency supply and strong demand by US banks and Asian buyers. In the ABS space, concerns continue to rise regarding the deteriorating credit performance of loans originated in 2006. The ABX index BBB tranche widened markedly in December. The outlook for CMBS remains robust as valuation of the underlying collateral remains relatively attractive.

Commodity Strategies. Commodity markets picked up in the fourth quarter after a ragged summer but there was

no extensive year-end rally comparable to that seen in the wider equity and bond markets.

Relative value commodity managers had a good quarter in general with particularly strong performance in the final month of the year. Oil markets were hanging on the words of OPEC as the oil-producing cartel found the recent heady drop in prices against its liking. Production quotas of the group were cut by 1.2m barrels/day in October and by a further 0.5m barrels/day in December, though concerns remain about the willingness of members to abide by their commitments. The US natural gas market weighed up the contrasting factors of cool weather in October and a quick cold snap in late November against healthy storage supplies. December settled the argument firmly in favour of the bears however, as the month turned out to be one of the warmest on record and gas quickly succumbed to the downward pressure through the month.

Base metals continued to be attractive for hedge funds in the fourth quarter though signs of physical supply response and demand reductions led to some caution. Copper had taken the lead in the metal run-up earlier in the year but rising inventory levels at the exchange warehouses signalled a reduction in market tightness. The 3-month LME contract responded accordingly, falling back below the USD6,500/ton price last seen in April. Zinc and nickel were linked to their own dynamics and however and bukked the trend to register solid price rises as lagging supply and low inventories pushed the market higher.

Agricultural markets continued to attract high interest with regular reports of new ethanol plants and regulations to introduce crop-derived fuels for transportation. This quarter also demonstrated the flip side of the markets however as some traders and funds were punished in a large move in the wheat market. Positioning for continued weakness in this market was a popular strategy during the summer but in October a rapid price rally caused a reversal in the Chicago wheat spreads that left some funds nursing losses and actually pushed some Board of Trade locals under completely. Corn was sucked into the resulting turmoil but has since responded more to the continually dropping estimates of crop availability to register impressive gains.

Insurance linked strategies closed out a profitable year with no significant events occurring to spoil the gains. Capital requirements prompted by the losses of 2005 and

Table 2 I Hedge Fund returns

Hedge Fund Strategy	Q4 2006	Ret pa 2000-2006	Ret pa 1994-2006	Stdev pa 2000-2006	Corr MSCI 2000-2006
FTSEhx (investable, net of fees)	**2.66%**	**6.30%**	**n/a**	**3.03%**	0.35
HFR Funds of Funds (non-investable, net)	**5.33%**	**6.26%**	**7.68%**	**4.43%**	0.58
HFR Hedge Funds (non-investable, gross)	**5.20%**	**7.77%**	**7.02%**	**4.74%**	0.37
CSFB/Tremont HFs (non-investable, gross)	**3.82%**	**7.73%**	**n/a**	**2.79%**	0.25
Emerging markets	11.42%	14.32%	11.49%	10.69%	0.76
Distressed securities	4.97%	13.02%	12.40%	4.63%	0.50
Event driven	5.90%	10.79%	13.52%	5.84%	0.71
MBS arbitrage	2.05%	9.05%	9.65%	3.70%	0.09
Relative value arbitrage	4.49%	8.75%	9.84%	2.14%	0.38
Macro	5.47%	8.17%	10.07%	5.60%	0.29
Convertible arbitrage	2.77%	8.22%	9.34%	3.33%	0.08
High yield	3.01%	7.62%	7.63%	3.46%	0.48
Long/short equity	5.38%	7.66%	14.27%	8.04%	0.73
Merger arbitrage	5.65%	7.52%	10.23%	3.40%	0.45
Short-selling	-1.75%	5.75%	0.66%	21.11%	-0.71
Fixed income arbitrage	1.61%	6.60%	6.04%	2.30%	0.07
Market neutral equity	2.53%	6.07%	7.98%	2.77%	-0.04
CTAs	3.12%	5.48%	5.71%	7.68%	-0.14
Sector specialists	6.01%	5.95%	14.15%	13.94%	0.65
Statistical arbitrage	3.96%	4.79%	7.64%	3.74%	0.60
MSCI World	**8.02%**	**0.62%**	**7.23%**	**13.89%**	1.00
JPM Global Bonds	**1.59%**	**5.84%**	**7.03%**	**2.94%**	-0.31

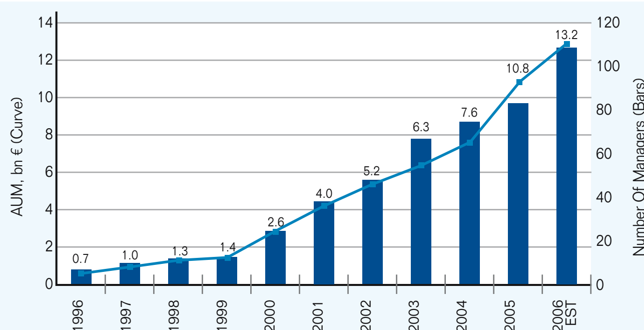
Source: Harcourt, HFR, MSCI, JPM, FTSE, CSFB

Harcourt celebrating 5 years on ground in Nordic region

As the first global fund of hedge fund manager, Harcourt established an office in Stockholm in 2001 with client service and research capabilities dedicated to the Nordic region.

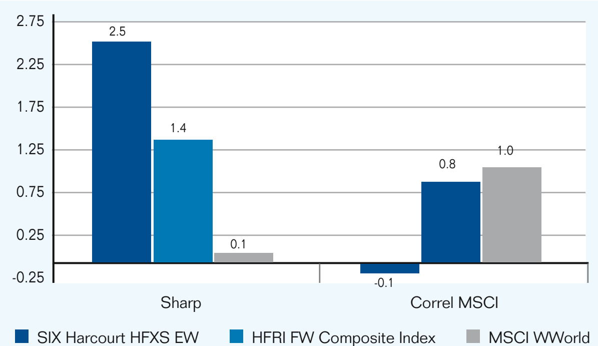
In the Nordic region, Harcourt saw a hedge funds industry emerging with talented managers and professional investors increasingly embracing the absolute return philosophy. This has been proven right; the graphs illustrate the size and performance of the Nordic industry in recent years. Both in terms of asset growth and risk adjusted performance, the Nordic region has achieved impressive results.

Nordic hedge fund growth (1996 – 2006)



Source: Harcourt Research

Risk adjusted performance and correlation (2001-2006, hedged SEK)



Source: Harcourt Research, Hedge Fund Research, MSCI (SEK hedges by Harcourt)

Also for Harcourt's Nordic operation local presence, the period has been prosperous. During the five years Harcourt has attracted institutional capital and partnerships across the whole region. Harcourt Nordic has established itself as an active participant in the region's hedge fund development and education vis-à-vis investors, hedge funds and media alike. To create a regional benchmark, Harcourt was also instrumental in launching the first Swedish hedge fund index (SIX Harcourt HFXS index) during 2005.

The five year anniversary of Harcourt Nordic was celebrated with a dinner reception which media reported was populated by the "local hedge fund elite". We thank all our business partners in the Nordic region for the past 5 years and are looking forward to an exciting future.

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increased regulatory conditions should also underpin the market for the new contract year in 2007.

Directional Multi-Asset Class. Macro managers finished the year on a positive note (+5.47%). They were able to capitalise on positive sentiment in the equity markets, strong currency movements (as the USD finally weakened against a basket of currencies at the end of November) and positive emerging markets. In each month, macro managers posted positive returns, with only commodity positions weighing on performance. Going into 2007, we expect a number of trends to materialise and volatility in the markets to pick up, both of which should be positive for the performance of macro funds. Macro managers disappointed somewhat in 2006 (+8.75%). The performance in the 4th quarter saved the year, but the period from May till September was particularly difficult.

Long-Term Trend-Following CTAs had a good quarter (+3.12%), taking advantage of a number of clear trends in the markets. In particular, the USD/JPY cross proved beneficial in November and equity markets also contributed significantly to the good performance. Interest rates were tougher to trade, since no clear trends developed during the quarter. This range trading environment is typically difficult for CTAs. Energy positions were negative in October and November, but losses were pared in December as CTAs put on positions benefiting from the negative trend in energy prices. Short-Term CTAs had a good October and November, but gave back some of their performance in December, as they got stopped out of positions on several occasions without finding a trend. Going into 2007, the strategy should perform well if trends develop and volatility picks up.

Outlook for Q1 2007

In our view, the hedge fund strategies with the highest return potential for the next quarter are Long/Short Japanese equities, Long/Short Emerging Markets equities, Merger Arbitrage and Event Driven. A generally benign outlook is backed by strong mergers and acquisitions activity, potential expansion of P/E ratios and low corporate default rates. The ongoing search for yield continues however and investors remain willing to pursue risky assets. With a near-consensus opinion that the US will experience a 'soft landing' and almost universal bullishness for 2007, it is worth remembering that any deviation from these expectations will quickly change the market outlook.

We expect returns from diversified funds of hedge funds to maintain a range of Libor+500 bps pa with contained volatility.

Picture: Rio de Janeiro

Latin America – Is it the next hedge fund investment opportunity?

By Neil Paragiri I Harcourt AG

Over the past several years, our industry has witnessed the migration of hedge fund flows starting with the United States, then expanding to Europe and in the past two years moving to Asia. Why? Because the US has become a much more efficient and crowded market for hedge fund investing. A plethora of funds chase the same or fewer arbitrage opportunities. To a large extent, this increasingly applies to Europe as well. Moreover, significant inflows have gone into Asia for the past 2 to 3 years, somewhat crowding out that market. Where does that leave the investors who are seeking new horizons and new frontiers? For the US investors, they do not have to look too far from their backyard and for others just a bit farther. A diverse set of emerging economies, known collectively as Latin America, is evolving into providing interesting hedge fund investment opportunities.

There is a prevailing perception of Latin America as being largely commodity driven, laden with debt and heavily dependent on the growth of US economy. This is debatable. Over the past decade, there have been significant structural changes in Latin American economies. With the exception of Mexico (due to NAFTA) and Venezuela (heavily dependent on oil exports to the US), other Latin American countries are becoming far less dependent on the US economy (Figure 1). Also, Latin American countries have managed to reduce their debt levels considerably (Figure 2). They have seen substantial foreign reserve increases across the board, and have enjoyed relatively low inflation (Figure 3) by historical standards. Consequently, most of them today have built current

account surpluses (Figure 4).

These are as a result of a culmination of global growth, companies becoming more efficient, better governmental policies and improved governance, just to name a few. The sovereign debt of some of these counties is expected to attain investment grade ratings in the next few years. Unlike in the past, where Latin America's economic growth was largely dependent on commodities and agriculture, the economic growth these days is more derived from other sources such as domestic consumption, industrial exports, consumer credit (housing and consumer finance), exports to China, India and other Asian economies. However, the GDP growth in Latin America is relatively moderate and does not reflect what one would expect in successful growing emerging market economies – particularly for a large economy like Brazil (Figure 5).

Notwithstanding, correlation with commodity prices, development of large Asian economies, continued expansion of US economy, regional politics and governmental policies will remain some of key risk factors in the foreseeable future until these countries become efficient self-sustaining economic engines in their own rights. There is not a complete de-coupling of Latin America from the US yet because even recently in early January 2007, the inflationary expectations in the US and falling oil prices lead to a pronounced drop in most of the Latin American equity markets. Could China impact Latin America more than the US in the future? One could argue that a slowdown in China could have more adverse impact to Latin America in the future than the US.

And we should not forget India, a country that can create even greater demand for what Latin America has to offer going forward. What if India continues to grow for years to come? Could it dampen the impact of a slowdown in the US or even China? Nevertheless, the long-run scenario is that the demand for commodities and exports of Latin America is expected to be sustainable for the foreseeable future.

Hedge funds in Latin America

Given the backdrop of the above economic scenario, Latin America may prove to be an ideal environment for the local hedge fund industry where significant inefficiencies and volatilities continue are in abundance for the skilled arbitrageurs and experienced stock pickers. By some counts, there are approximately over 300 hedge funds focusing on Latin American markets, managing more than USD40b in aggregate. Although these figures are relatively small when compared to the hedge fund industry as a whole, the hedge fund industry in Latin America has grown over 50% in the past 2 years.

There are various ways for hedge fund investors to take hedge fund exposure to Latin America. For instance, some global macro managers have built expertise investing in the Latin American markets. Likewise, CTA (Commodity Trading Advisors) funds have been trading currencies, fixed income and equities in emerging markets; the same goes for fixed income managers who are specializing emerging market debt and distressed securities. However, investors will find that often these managers' exposure to Latin American markets is more limited and also opportunistic because of their global trading nature and for diversification reasons. Likewise, institutional investors have generally shied away from Latin

Figure 1 | Latin American exports to the US

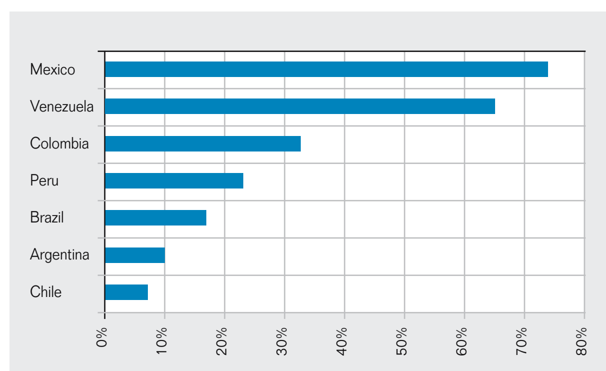


Figure 2 | Latin American debt levels

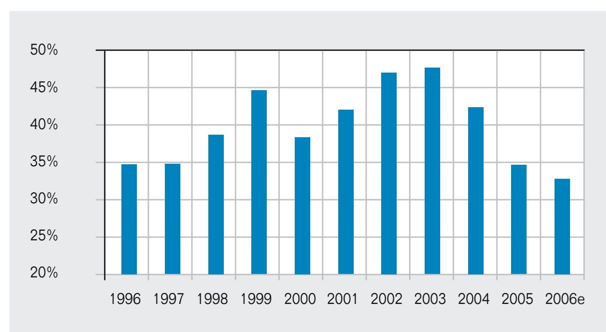


Figure 3 | Latin American inflation

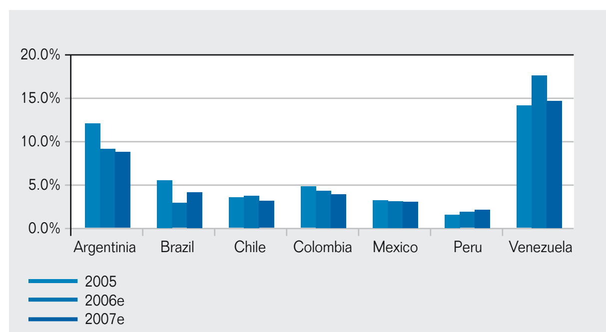
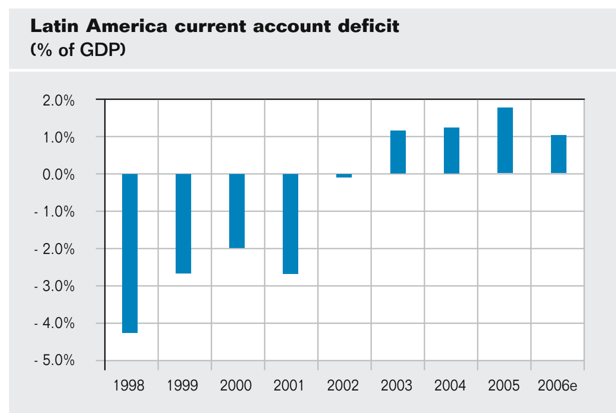


Figure 4 | Latin American current account deficit



America because of the perceived volatility of the emerging markets, for which there are many examples in the past. It goes without saying that local hedge funds have not been on the institutional radar screens either.

However, we today believe that Latin America is evolving into a legitimate hedge fund market much like Asia a few years back.

A good way to access Latin American hedge fund markets is through a combination of global managers who have a substantial dedicated exposure to these markets as well as utilizing local managers who have developed country expertise. Although some might argue that being local may be disadvantageous for understanding global changes, it is our experience that the local hedge fund managers are keenly aware of how global events can impact their investment activities. To put it another way: how many investors will invest with a hedge fund manager based in Asia trading US markets?

As the local Latin American managers have experienced tail events at least once every year, they have by and large become better at navigating through major drawdowns during a crisis. Furthermore, for most asset classes, local knowledge constitutes a competitive edge. Because of their frequently limited size, several securities may not even be on the radar screen of global hedge funds.

Another area where local knowledge plays an important role is in selecting small and mid cap stocks - these companies are not often followed by analysts even at the local financial institutions. Yet, they provide attractive investment opportunities for the local hedge funds.

A vast majority of local funds are based in Brazil and a large number of those funds are on-shore, catering to local investors. Besides Brazil, there are a handful of funds based in Argentina. Very recently, hedge funds are being setup and planned in Chile and Peru. Quite interestingly, hedge funds are virtually non-existent in Mexico. In part due to its proximity to the United States, the hedge fund managers who invest in Mexico are often based in Florida or New York. Besides the local managers, there is a vast pool of hedge funds based in the US and UK focusing on Latin America.

The range of strategies pursued by these funds is broad. A significant proportion of the managers are split between macro, multi-strategy and long/short equity strategies. Other available strategies include fixed income arbitrage, relative value equity, emerging market debt, and even asset based lending.

Historically, Latin American hedge fund returns have far exceeded diversified global hedge indices (Figure 6). Since the beginning of 2001, the Latin American hedge fund Index has enormously outperformed any other geographical hedge fund indices. However, the investors should be aware of the higher volatility and the risks associated with emerging markets. It is worth discussing how Brazil and Argentina provide some interesting local hedge fund investment opportunities.

Figure 5 | Latin American GDP Growth

Real GDP Growth	2004	2005	2006	2007e
Argentina	9.0%	9.2%	8.6%	5.9%
Brazil	4.9%	2.3%	2.9%	3.0%
Chile	6.2%	6.3%	4.8%	5.3%
Colombia	4.9%	5.2%	5.2%	4.5%
Mexico	4.2%	3.0%	4.3%	3.6%
Peru	5.5%	6.4%	6.4%	6.0%
Venezuela	17.9%	9.3%	8.1%	5.0%
Region	5.6%	3.8%	4.3%	3.7%

Source: UBS

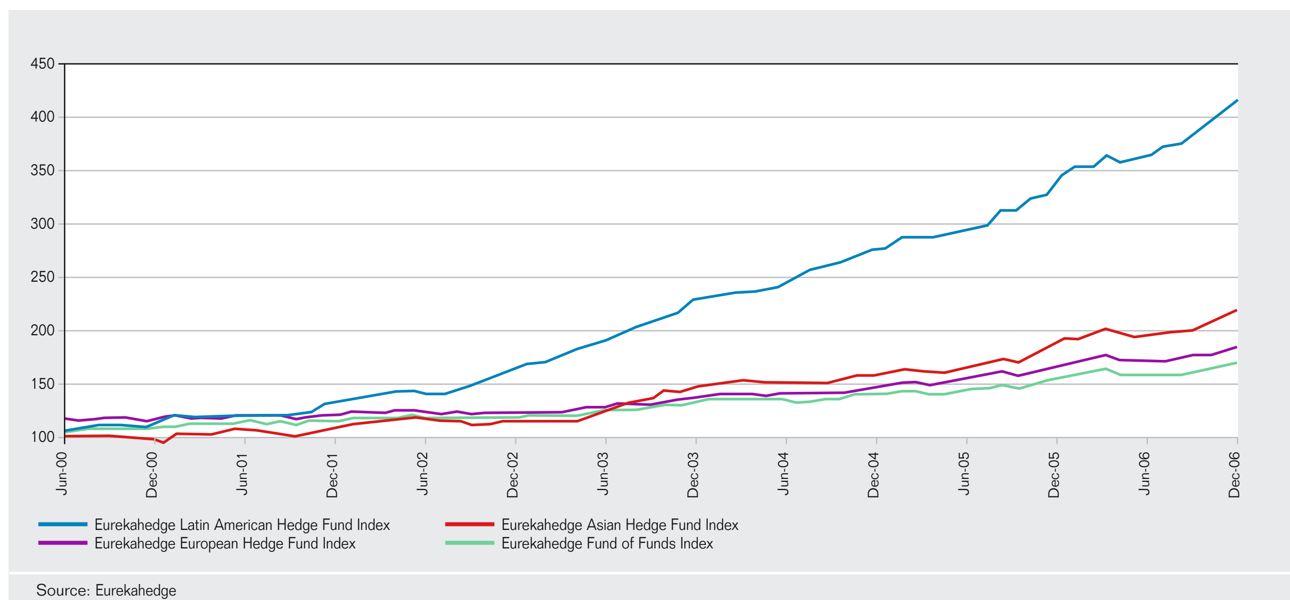
Brazil

Brazil has been in the forefront of the Latin American hedge fund industry in terms of talent of the hedge fund managers, availability of financial instruments, and improved liquidity. Brazil's hedge fund industry has been in existence since the mid '90s. Initially catering mainly for local investors, recently these managers have become more active in soliciting off-shore capital. By Harcourt's estimate, there are approximately 60 hedge funds in Brazil with off-shore structures for the non-Brazilian investors today. We expect this number to grow significantly in the coming years.

The Brazilian on-shore funds are highly regulated. The funds are required to provide daily liquidity, be registered with Comissão de Valores Mobiliários (CVM), Brazil's local SEC), and provide a high level of transparency with the

portfolio holdings reported by CVM with one-month lag.
Brazil is the largest of the economies in Latin America. In the past few years, there have been remarkable structural changes that make it an attractive market for the hedge funds. With improving dollar reserves (currently at USD86b), Brazil can continue to better manage its liabilities in the coming years. Brazil also has an improving current account benefiting from the global demand for its commodities. At 13.5%, the local CDI rates are still high although the Central Bank has been actively lowering rates. At inflation around 3%, the real rates are still at high levels of 10% although significantly lower from the historic levels.
While globally, central banks are continuing to increase interest rates, Brazil is one of the few countries where lower interest rates are expected in the near future (assuming that inflation continues to be benign). This could result in improvements in the consumer finance and mortgage lending areas.
Brazil is a relatively young country. Some 50 to 60 million consumers are in their 20's, it being very attractive population segment associated with a high rate of personal consumption.
Another area of potential growth is in asset based lending. Hedge funds are beginning to offer financing services in the areas of agriculture and consumer finance.
The equity markets in Brazil are also going through significant changes. More and more companies are adopting what is called "Nuevo Mercado" (new economy) listings. Historically, investing in Brazilian equity markets presented interesting challenges. Most of the companies issued shares with voting rights and non-voting rights and the voting shares were always held by a few owners. Nowadays, some of the local hedge funds have begun to play activist roles by challenging the voting share holders to adopt better business models and

Figure 6 | Hedge fund performance Asia, Europe, Latin America



Source: Eurekahedge

encouraging companies to more aggressively follow the tenets of shareholder value creation. There is also increased liquidity in the Brazilian market in the recent years with more ADRs and increased shorting opportunities.

The Brazilian hedge fund industry is largely dominated by multi-strategy (macro) and long/short equity funds. There are, however, more choices to investors including fixed income arbitrage, event-driven, and market neutral funds. Multi-strategy managers tend to have substantial exposure to equities, trade Brazilian Real against USD, and trade a limited number of fixed income instruments.

It is important to highlight is that Brazilian hedge fund managers today almost exclusively trade Brazilian markets only with a few exception. For this reason, what an investor can expect from a Brazilian manager is pure Brazilian exposure.

Argentina

The economic growth of Argentina, coming out of its default, continues to be strong with GDP growth of 9% in 2006 and 7% expected growth in 2007. The country has gone through important changes since the default.

As shown in Figure 5, Argentina's economy has recently been one of the strongest economies in Latin America. In 2005, its current account surplus was 1.6%. The trade surplus of USD11b was mainly supported by high real exchange rate and sustained prices of commodities.

The country still has several structural and regulatory reforms to be completed (including the utilities sector), and also has one of the of the highest inflation rates in Latin America. The inflation is somewhat contained by price controls. As the

government eases those, the inflationary pressure would have a dramatic impact on the economy. After the default, Argentinean companies have substantially improved their balance sheets and debt servicing capabilities.
The equity market is also showing signs of revival, although there is a lack of liquidity and limited shorting capabilities (except ADRs). The way for an investor to take exposure to Argentina is largely through the fixed income market in restructuring, sovereign debt, and corporate hold-outs. As the presidential election in Argentina is to take place by the end of 2007, investors need to be mindful of the policies the new government is likely to carry out in terms of price controls on energy, dealing with hold-out sovereign debts and its ability to control inflation.
There are currently a limited number of hedge funds in Argentina. By Harcourt's estimate, there are only 8 local hedge funds today. A few of those invest outside of Argentina to diversify their exposure but similar to Brazilian managers, their expertise lies within Argentina. Argentinean focused funds attempt to take advantage of the recovery and as equity market conditions improve, we expect these funds will continue to evolve taking more equity exposure.
In conclusion, we believe Argentina also provides an interesting hedge fund investment opportunity and we expect to see more hedge funds in Argentina in the coming years. Argentina was indeed a very dominant economy in Latin America a few years ago and there is a lot of hedge fund talent and experience that can be harvested in this country.

Other countries

Other countries such as Chile, Peru and Colombia all are increasingly becoming important economies in the region as their markets become more open, thereby providing interesting opportunities for foreign investors.
For instance, Chile has be one of the best managed Latin American economies for a long-time and continues to enjoy a stable political environment. However, Chile's growth is very much dependent on copper prices and the demand for copper in the global markets. Chile is actively taking measures to avoid such dependence.
Colombia was a relatively closed economy to foreign investors and the re-elected President Uribe has made marked improvements in terms of security and also signed a comprehensive free trade agreement last year with the United States, opening the door for an increase in bi-lateral trade.
Peru has experienced substantial growth as a result of commodity boom and remains vulnerable if the commodity prices fall.

Political risks

There are numerous risks worth discussing; but one stands out: the political environment.
The leftist government policies in Venezuela, Bolivia and to a lesser extent in Brazil could have a profound impact on the economic growth of this region. When President Lula da Silvia was elected for the first-time, there was a great deal of uncertainty on Brazil's economic future due to his socialist policy platform. He has proven to be more moderate than most people had expected.
Recently, Mexico's president Felipe Calderón was narrowly elected whose candidacy was fiercely opposed by his leftist opponent Andrés Manuel López Obrador who continues to challenge any sweeping market reform agenda.
At one end of the spectrum, Venezuela's president Chavez has been publicly promoting a heavily socialist agenda. Even at the time of this writing, President Chavez announced his plans to nationalize Venezuela's largest phone company, CA Nacional Telefones de Venezuela and also take greater control of the oil industry. Such postures which may be real or anecdotal may keep foreign investors and institutions shying away from Venezuela.

Conclusion

What can one possibly draw from all these assessments about Latin America? Will the boom result in sustainable returns?
The answer largely depends on the time horizon taken by investors, and by their ability to identify hedge fund managers who can successfully generate alpha by taking advantage of the long-term improving fundamentals of these economies. At the same time, both hedge funds as well as their investors need to be mindful of short-term volatility and systemic shokks. We encourage investors to take a long-term perspective in order to achieve high rates of returns, and to accept short-term market volatilities.
Diversified portfolio allocation is quite important for investing in Latin America. Such a portfolio should consist of local and global hedge fund managers with vast experience trading in local markets and countries, different strategies and those managers who have experienced various market crises. As the liquidity and the shorting capabilities in these markets improves, we expect to see more managers establishing hedge funds and are determined to play a role in the development of this emerging hedge fund market.

Picture: Buenos Aires

New players enter the game – is Latin America ready for hedge funds ?

By: Christopher Palmer I Gartmore UK

Equity markets in Latin America have performed strongly in recent years as a decade of reform and liberalisation has begun to yield results. Since January 1, 2001 the MSCI Latin America Index has risen by more than 200%, outperforming most other asset classes, including many other emerging markets indexes (Fig 1). Considerable improvements in the terms of trade for Latin America have played a large role, as has the notable improvement in the region's overall inflation and interest rate scenario. With military governments ceding control in the past two decades to elected civilian governments, the best results may be yet to come for this exciting equity asset class.

We are particularly excited about the prospects for hedge funds now that they possess the tools and the fundamental catalysts needed to prosper. In a market traditionally dominated by money market funds, there is an important shift under way in the equity investment arena. Macroeconomic stability is likely to unleash a sustained wave of equity buying over the next few years in Brazil as institutional investment grows and equity weightings in Brazil's large investment management industry increase. Equity hedge funds offer enormous potential for capitalising on these structural changes.

Chile paves the way

The evolution of the Chilean equity market over the last twenty years provides some important insights into the impact of structural change on equity market valuations. In 1990, the Chilean military ceded control to an appointed civilian government, which introduced wide-ranging reforms including the replacement of government social

security with new mandatory employee-funded pension schemes. Many state-owned companies were privatised, further removing the state from private enterprises. With the implementation of tight fiscal controls and policy incentives designed to boost export competitiveness, Chile began to enjoy both a balanced budget and sizeable trade surpluses. Local interest rates fell from 38% in 1982 to just 1.9% by 2004 (Fig 2).

In the late 1980s the stock market was further liberalized, culminating in the listing of Telecom Chile on the New York Stock Exchange in the early 1990s (Figure 3.). In subsequent years Chile slowly opened up its local stock market and fixed income market to foreign investors. The combined effects of more sophisticated capital markets, improved liquidity, falling inflation and declining real rates led to the creation of a vibrant equity market.

However, the Chilean experience has not been without its pitfalls. Corporate governance guidelines to regulate the behaviour of Chile's new generation of business leaders remain less stringent than those of developed markets. Pension funds in Chile are generally unwilling to confront poorly performing managements and are by design risk-averse. A chronic over-supply of capital to the equity market has led to complacency amongst business leaders and in many cases declining returns on capital. As a result, Chile's equity market has achieved only a fraction of its potential. Nevertheless, Latin America market participants, regulators and government officials have witnessed the remarkable changes in Chile and are striving to expand on the market's early success.

Roadmap for Brazil

With a GDP of USD793b, Brazil is the largest economy in South America, well deserving of its title the 'Engine room of Latin America'. Brazil's investment management industry is also relatively large, with total system assets of USD568b as of October 2006. Brazil already enjoys having its own sophisticated financial market, including its own financial futures exchange, so the evolution towards hedge funds should prove easier than in those countries with lesser liquidity and hedging tools.

Given the improved macroeconomic environment and more stable political structure now in place, it is possible to envisage two major catalysts for improvement in the equity market in Brazil; first, the market should witness a steady increase, from a low base, in overall equity exposure. Second, there should be a trend of steady growth in Brazil's own investment management industry, whose mutual funds and other vehicles are displacing pension funds as the key driver in the financial markets.

The macroeconomic picture in Brazil has improved dramatically in recent years, providing an important backdrop for the evolution of the equity market. In the mid 1990s, Brazil embarked on an ambitious program of economic reform and political liberalisation, culminating in the privatisation of key state-owned companies such as Telebras and Vale Rio Doce (Fig 4). However one key tenet of Brazil's economic policy was a semi-fixed exchange rate - effectively an inflation 'anchor' – a strategy that proved disastrous in Mexico and was soon to play out badly in Brazil as well. Spurred on by the Russian crisis and an almost perpetual series of lesser crises in Asia, Brazil's currency was forced to float freely, resulting in it halving in value between 1998 and 2002.

The inauguration of Lula in 2002 as President marked the low point in Brazil's recent economic history, but ironically the Presidency of Lula da Silva has proved to be extremely lucrative for fixed income and stock market investors in Brazil. Early 2003 saw interest rates peak at 26% and inflation spike to nearly 17% per annum as investors lost faith in Brazil's currency, which was rapidly losing its purchasing power (Fig 5.). Lula's administration was able to win over its critics by sticking to the terms of a draconian IMF austerity plan and by providing incentives designed to increase Brazil's share of global trade.

In subsequent quarters, Brazil's trade surplus began to swell as assertive trade policies, mixed with some good fortune, led to a sharp increase in the volume and dollar value of exports (Fig 6). With tight fiscal controls in place, Brazil's burgeoning current account surplus has slowly led

Figure 1 | MSCI Latin American index 1991-2006

Source: Bloomberg

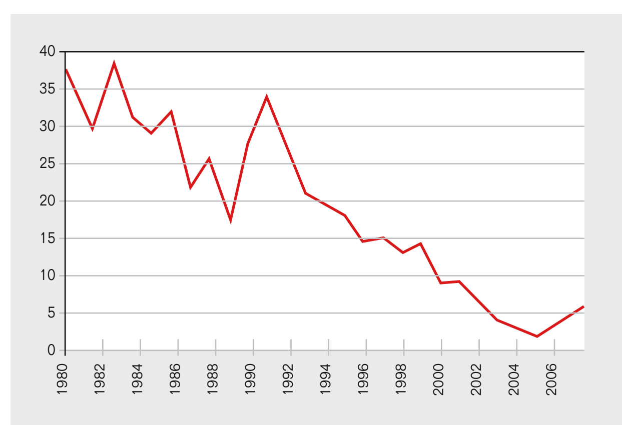
to a marked improvement in Brazil's debt position. Net public debt as a percentage of GDP has fallen by over 10% since 2002, boosting confidence in Brazil's domestic bond market. New-found confidence in Brazil's own currency has also led to a recovery in the exchange rate, which is of major benefit in the fight against inflation. Consequently, Brazil is now in the best position it has been in decades to cut the real rate of interest, stimulate growth, and raise overall investment rates.

Sea Changes in Brazil's asset management industry

Traditionally, equity investment in Brazil has been dominated by the pension funds of state-owned companies such as Previ, Petros and Sistel. Their financial clout made many of the privatisations in Brazil in the 1990s possible and today many of these funds continue to hold large stakes in former state-owned companies. Riskier funding for capital investment in Brazil is possible through the lending and investment arms of the BNDES, Brazil's state-owned developmental investment bank. Persistent high real interest rates have meant that few pension funds have maintained high equity weightings, and investments have been for the most part limited to the export sector. Of the estimated USD147b assets held by Brazil's pension fund industry, about 29% is invested in equities, a number unlikely to increase as strong returns in recent years have led to an over-funded condition for many funds. However, recent trends in Brazil would indicate that these traditional pension funds will soon be giving up their leadership in the equity markets to institutional investment managers, and in the not too distant future, to hedge funds.

The private fund management industry offers even greater prospects to drive stock market returns in the next decade. With over USD400b in assets under management, Brazil's institutional investment industry has its largest holdings allocated to short term fixed income investments. In the past ten months however, the average allocation to equities

Figure 2 I Nominal annual monetary policy



Source: Celfin

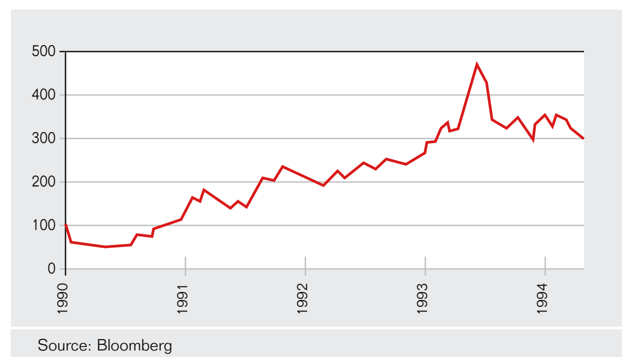
has risen from 11% to over 13.5%, generating over USD11b in net equity purchases. If private institutional managers were to boost their holdings to a weighting similar to that of the Brazilian pension funds, nearly USD60b would enter the Brazilian equity market by 2010. In emerging markets, local investment flows play an important role in determining the psychology of foreign investors – this type of catalyst amongst locals could lead to elevated foreign portfolio flows as well.

In early 2006 the Brazilian government relaxed certain parts of its complex tax code, easing restrictions on foreign investment in Brazilian government debt and real estate investment funds. Formerly subject to a 15% withholding tax on government debt profits, foreign investors from countries which have tax treaties with Brazil, as well as traditional pension fund investors outside of Brazil, can now buy government debt free of income tax. Likewise, profits relating to investments in real estate funds are also now free of taxes for eligible foreign investors. These moves provide important incentives for foreign investors to use lower cost funding offshore to purchase Brazilian assets, while at the same time providing the critical catalyst for longer term interest rates and property yields to converge towards the regional mean.

Capital markets have responded to the improved economic picture in Brazil by offering new investment instruments and derivatives contracts, while Initial Public Offerings ('IPOs') have multiplied. For example, there have been 51 IPOs in Brazil and other Latin Markets in 2006, raising over USD13b in funds. IPOs are a useful barometer for market sentiment, and the high level of activity in 2006 certainly points to a new confidence in Brazil and its neighbours. In early 2000 two popular exchange traded funds, I-Shares MSCI Brazil and I-Shares MSCI Mexico were introduced, allowing investors easier access to markets. I-Shares Brazil has ballooned in popularity and size with trading volumes expanding from roughly 300,000 shares a week in 2001, to somewhere over 20 million shares per week in 2006.

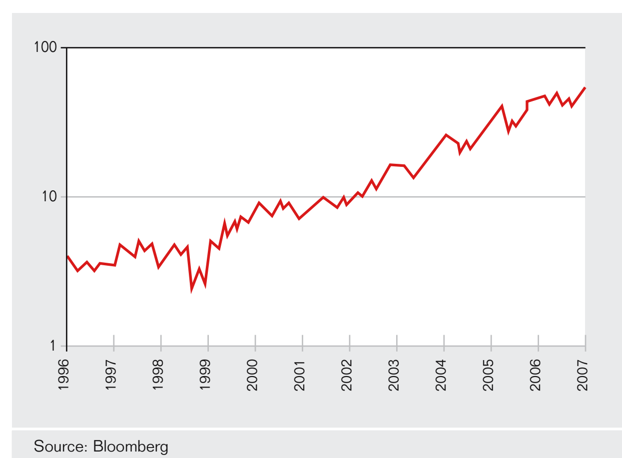
One interesting development for hedge funds has been that investment banks that provide custody for the I-Shares program have been able to create vital stock loan programs for those hedge funds and arbitragers looking to 'sell short' local Brazilian shares. Because of historic credit and legal problems in the interbank market in Brazil, stock lending for short sales has generally not been widely available. The growth of exchange traded funds has allowed for an offshore swaps market to develop under the auspices of the International Swaps Dealers Association ('ISDA') that has

Figure 3 | Telecom Chile ADR rebased to 100
July 1990 - December 1994



Source: Bloomberg

Figure 4 | Cia. Vale do Rio Doce ADR

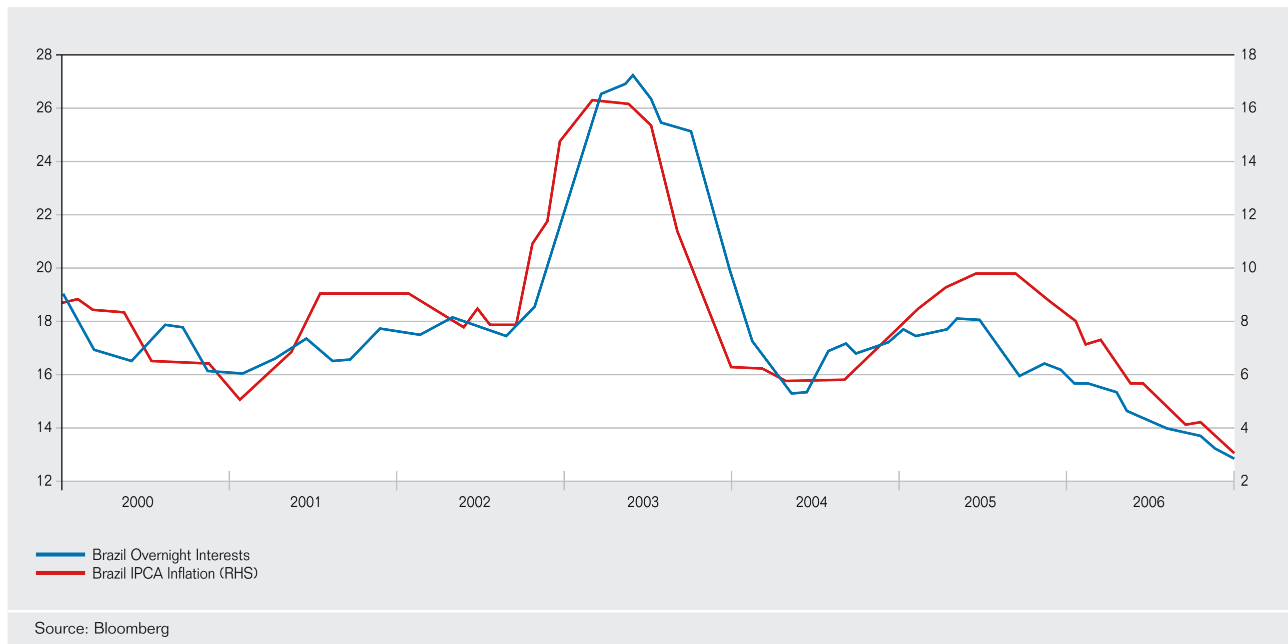


Source: Bloomberg

taken the place of the more usual interbank securities lending market prevalent in the USA and Europe. Effective ability to sell short could transform the Brazilian equity market from a traditional 'long only' environment to one where other strategies, such as long-short equity hedge funds, might prosper. The availability of short selling can also help to add depth to the market and allow for more flexible approaches to option markets and option market making.

Another innovation that could boost trading of Brazilian equities by risk-conscious hedge fund managers is the use of credit default swaps ('CDS'). The adoption of CDS in the equity trading environment has important implications for investment in sub-investment grade developing markets such as Brazil. With periods of financial or political instability fresh in investor memory, the use of credit default protection could prove popular amongst equity hedge fund managers. CDS have been around for years, largely used by arbitragers looking to offset specific unwanted exposures, but their wide-scale use by equity managers seeking to hedge out cataclysmic sovereign event risk could provide much needed 'disaster protection'.

Figure 5 | Brazil interest rates and inflation, January 2000 - November 2006



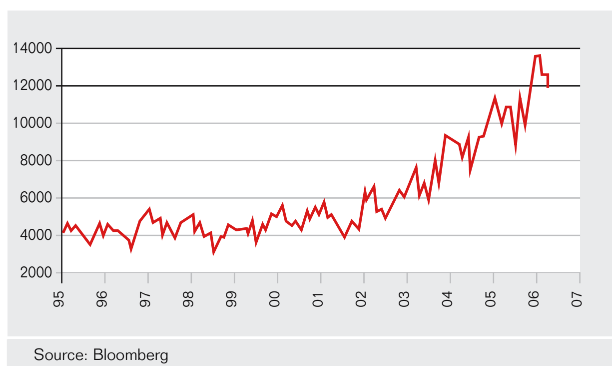
Source: Bloomberg

Spreading Out. Implications for Mexico

The Mexican equity market should also see some structural improvement in coming years as a result of the increased use of equities in pension funds. The most common platform for investment savings in Mexico is the AFORE, a mandatory contribution pension fund, typically managed by a bank or institutional investment manager. These funds have had extremely low weightings in equities in recent years, with exposures ranging from 0 to 1%. However recent changes to the legislation of AFORES now mean that it will become easier for them to add unprotected equity exposure. With nearly USD800m per month pouring into these funds, it is only a matter of time before we see an increase in equity exposure.

For hedge fund managers, the real opportunity in Mexico could be the broadening of the overall stock market, particularly if AFORE fund flows result in more IPOs and new equity placements by existing small and mid-cap shares. Short sales are a well-established practice in Mexico as book-entry record-keeping, legal structures and a vibrant interbank market have all allowed the practice to flourish. However, a key missing ingredient for Mexico remains the futures market for equity index, or lack thereof.

Figure 6 | OECB Brazil foreign Trade Exports FOB | July 1995 - November 2006 | in USDm



Source: Bloomberg

Conclusion

Following on from the success of Chile in the early 1990s, Latin America's equity markets are set to enter a new period of growth and sophistication. Regardless of one's opinion about the near term direction of individual markets, structural changes are likely to occur in Brazil and Mexico that should substantially improve the breadth and scale of the domestic equity markets. The introduction of equities to pension funds should improve overall liquidity conditions and generate important incentives for new equity listings. With new derivative products available and improved access to short sales, it is only a matter of time before hedge funds begin to play an important role in the region's markets.

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Picture: Manaus

The many faces of Latin America

«News behind the news» | Author Matthias Knab edits Alternative Market Briefing (published by Opalesque Ltd). In this column, exclusively available to swissHEDGE readers, he reflects and analyses what is behind current topics that dominate the industry and the media.

The quality of your decisions is determined by the quality of your information. When it comes to investing and asset management, especially abroad, I have always believed it helps to have a local base, access to "hands-on" expertise. Another dimension is acquired by visiting the country, at least once. Ideally you should give yourself enough time to get a feel of the country: to build meaningful insights and to learn about its economy, natural and "human" resources, its culture and its peculiarities.

For example, addressing India's failure in the development of Chinese-style special economic zones, the Financial Times recently pointed out that "if you're sitting in a hedge fund somewhere in London or New York and spending much of your time reading panglossian BRIC reports, it's quite possible to be completely oblivious to the social protests that are gathering pace and force across much of India. You will miss out, for example, on the fact that the government's strategy to promote industrialisation through the development of Chinese-style special economic zones has all but run into the ground. The significance of this is hard to overstate: SEZs were supposed to provide red-blooded industrialists with capitalist enclaves where they could escape from the stifling inspector raj, burdensome labour laws and high tax rates that hamper businesses in the country at large. They were meant to create millions of jobs by extending to manufacturers the same tax breaks and labour law flexibility that have helped make the country's IT sector world-class during the last decade. In the last few weeks,

however, it has become clear what a dreamy vision this was...."

Take a look, for example, at the extraordinary difficulties the state government of West Bengal has been having in securing land for flagship industrial developments. In the last quarter of 2006, the state's communist chief minister, Buddhadeb Bhattacharjee, expended virtually all his considerable political capital in forcing through the compulsory acquisition of farmland in the fertile Singur district so that Tata Motors could build a car assembly plant within easy reach of Calcutta. At one point, the protests reached such a pitch, with one opposition leader engaging in a lengthy hunger strike that almost killed her, that chief ministers in the rest of the country began to question whether Buddha, as he's known, had not made a massive miscalculation.

Buddha prevailed at Singur in the end and the land is now ready to be handed over to the Tatas, but social activists, including Booker prize winning author Arundhati Roy, campaigning on behalf of those displaced by such industrial projects, smell blood. Literally. In the first month of this year, in copy cat protests against another of Buddha's flagship projects, six people during the protests against a development by Indonesia's Salim group of a huge tract of land for a special economic zone at Nandigram. Buddha was forced into a humiliating retreat.

However, for my personal insights in India, please refer to my last contribution to swissHEDGE "India falling flat?" Let's talk about Latin America.

Colombia

In 1995 I started to learn Spanish. My numerous trips to Latin America together with a fierce resolution to master that language ensured progress within a surprisingly short span of time. Today I think learning to speak Spanish was one of the best decisions in my life. The ability to communicate and read a language provides access to intelligence in the language spoken by the natives – and this is priceless. Besides, there is something infectious about the Latin American lifestyle: the music, the sincere friendliness of the people, the "joie de vivre". The following are my subjective impressions on some Latin American countries according to recent trips and many conversations with locals.

I am just returning from Colombia, a beautiful country with amazingly friendly people. I can confirm that President Uribe, in power since 2002, has transformed the country. His father was a wealthy landowner and cattle rancher who was assassinated by the FARC guerrillas during a 1983 kidnapping attempt. Uribe promised a more intensive military campaign against the guerilla. I felt extremely safe during my time and my travels there and can confirm what travel guide "Lonely Planet" writes: "So far, Uribe has delivered and the security situation has drastically improved in Colombia, giving way to a new period of national optimism. Uribe's popularity has tilted to 80%, making him the most popular elected leader in Latin America." On May 28, 2006, Uribe was re-elected for a second presidential term (2006-2010), and became the first president to be consecutively re-elected in Colombia in more than a hundred years. Uribe received about 62% of the vote.

However, the country is still divided: there are areas where guerrilla or paramilitaries wield power – the fact that the government does not actually control parts of a country is hard to imagine coming from a Western country – and then there are the safe and prospering regions. At the beginning of January 2006, one story grabbed headlines - a previous minister, who was kidnapped and held as hostage for over six (6!) years by the guerrillas, managed to escape and after days of wandering and eating roots, found his way into "the 21st century", as he said. His eyes were sparkling and happy, but his face showed signs of ageing and malnutrition, not to speak of having to come to grips with the fact that two years after the kidnapping, his beautiful wife had given up the marriage and is now living with someone else. This is a typical example how NOT to do things in Colombia, explained a Colombian friend to me. "There are things and areas in Colombia where everyone knows you will run into trouble when you cross a certain line. The minister was kidnapped because he was travelling to a place where he was not supposed to be…"

As I wrote before, the good news is that the government has strengthened the military and reclaimed much of the land that was ceded to the guerrillas in the late 1990s. Although as long as there are drug consumers in Western countries, the illegal drug industry in Colombia and Brazil will operate and supply what "hip" and not so hip drug addicts demand. Colombia is the world's largest producer of cocaine, controlling 80% to 90% of the global markets. The 1980s and 90s were the hey-days of the drug cartels. In 1983, Pablo Escobar and other cartel bosses offered the government a "peace-treaty" where for immunity from both prosecution and extradition; they offered to invest their capital in national development programs, and, according to Lonely Planet "more tantalizing still, proposed to pay off Colombia's entire foreign debt, USD13b at that time." The

government rejected the offer and open war broke out. While the drug mafia was assassinating politicians, the government retaliated with confiscating nearly 1000 cartel-owned properties. Another low point was the bombing of an Avianca flight from Bogotá to Cali, killing all 107 passengers on board, intended to "just hit one guy on the plane", according to a local entrepreneur.

Geographically, more than half the country (56%) is woods and jungle – an extensive area east of the Cordillera. It is there where the drug cartels operate today, withdrawn from the rest of the country. While in the "old days", according to the locals, you could identify a Mafiosi by his hair cut, jewellery, clothing and manners, today the drug barons and their clout are ousted and have to go under-cover. According to locals, the country applies strict money laundering rules. Today "a Mafiosi won't be served in a bar or restaurant, nor would he be able to buy an apartment (due to strict anti-money-laundering rules)."

Sometimes a trifle of the almost immeasurable money the drug cartels make still finds its way back to the Colombian society. Also in January, the police confiscated around USD57m a large number of gold bars (worth USD6m) in the south-eastern city of Cali. The money was hidden in simple houses and allegedly belonged to Juan Carlos Ramirez Abadia, a member of the North of the Valley Cartel and for whom the United States is offering a USD5m reward. The Colombian government now says it intends to use the money for the construction of low-income housing in Cali.

Real estate and timber

In the safe and prosperous regions, particularly in the scenic Caribbean historic city of Cartagena (worth a trip!), with a sweeping oceanfront beach strip, which almost reminds one of Miami, is slowly being developed. About 10 years

ago, a local pioneering entrepreneur first set up "Hotel Las Americas" on the strip that lay outside the historic city. At the time, nobody thought it made sense – in fact they thought it would go bankrupt.. but the hotelier wasn't the only one developing a site there. On the strip, one today finds beautiful condominiums, and in Avianca's in-flight magazine you can find at least 20-30 different projects advertised. I stayed in a 250 square meter apartment, top floor, ocean front and beautifully fitted, which a stock broker from Barcelona just bought for EUR250k. The prices have been, and are expected to continue, rising by 20% each year.

I also looked at timber and noble woods. A Colombian relative of the stockbroker owns a business dedicated to exporting and planting noble woods. He said the Colombian government has started to copy a Chilean model to boost its forestry industry, particularly planting noble woods. In this plan, the government actually refunds 50% of the planting costs, which would be USD2k per hectare. We were looking at piece of land of 156 hectares and he thought of using 100 hectare to plant trees. Sixteen or eighteen years from now, the proceeds of just one hectare of timber would equal the land price for the full 156 hectares, at current prices. And realistically, timber prices know only one direction: north.. Each year there would be more demand, each week he could ship more containers to Asia and China than what is available.

On another interesting note, Latin American consumers are borrowing like never before and mortgages are set to explode. A Merrill Lynch report states that mortgages and consumer loans in Latin America are all set for a period of rapid growth. Alexander Batchvarov, the firm's head of international structured finance research, reviewed consumer borrowing data in eight of the region's major economies: Brazil, Mexico, Argentina, Chile, Colombia, Panama, Trinidad and Tobago and Jamaica. His findings are released in a book entitled the "Merrill Lynch Guide to Emerging Mortgage and Consumer Credit Markets". Increasing economic stability and expanding liquidity indicate that demand for housing and consumer credit will grow significantly over the next 10 years. I just read that Colombia's FX reserves are growing, a bank just reported 19% growth over the last quarter, and foreign direct investment has reached USD16m per day.

Chile

On an earlier trip in 2006, I visited Argentina, Chile, Uruguay and Brazil. While I had not been to Sao Paolo, and cannot include this Brazilian powerhouse in my reflections, I actually thought that Santiago de Chile was the most developed and prosperous city I have seen in Latin America. I lived in the business district, and just by looking at the architecture, the streets, the infrastructure and the way people dressed left me impressed. It almost felt like being in the US. Chile has become a rich country, and I also noted a very well developed educational system, which will continue to contribute to the country's prospects.

Of course, a few days later I drove to the Pacific ocean, and getting to know other Chilean cities and the country side quickly made clear that life outside of the capital still has that distinct Latin-American flavour. When I pointed out the advances I noted in Chile, especially comparing the country to its neighbours, some locals tell you the prosperity and development would be a result of Pinochet's reign and politics, focusing the country on "hard work and discipline".

Impressions of Argentina

You can still see some people begging in the streets of Buenos Aires, with the country's most unfortunate still suffering from the catastrophic events that hit country when it defaulted in 2002, the 11-year dollar peg was abandoned and all bank accounts were frozen. A friend of mine, a Colombian businesswoman, who was moving to Buenos Aires that year and lives there since, says the shock people suffered from not being able to access their bank accounts any more and the break down of the economy is unimaginable. Since the banks were closed, there was no access to

bank notes and the authorities were issuing a currency substitute that people used to barter. People also directly bartered services and goods without using a currency.

Still today, she believes that the Argentinean economy as still fragile and thinks the real damage has happened to the Argentinean psyche, to the "inside" of its citizens. "While in every country, more so in Latin America, you will find people complaining about the current state of affairs, the situation in Argentina seems different. Due to the relatively recent, painful experience, which many describe as "being robbed by the banks and the politicians", the average Argentinean appears to have lost hope on the country, its prospects, and worse, has given up initiative. Out of all Latin Americans, the Argentinean is the one who complaints the most and does the least. They go in circles. In fact, I thought of printing a T-Shirt, wearing it and point to it all day. It will say "Do it first, then talk to me about it!" "

Uruguay, Brazil

Uruguay. Just across the Rio de la Plata you find Uruguay. The Argentinean banking crisis also infected Uruguay, and when I was wandering through Montevideo in March 2006, I was struck by the contrasts between its prosperous past (like the marble-plastered parliament), when the country was still known as the "Switzerland of Latin America", and today's reality. For example, just a few blocks from the city center you'll run into abandoned streets where the only thing you'll find along the sidewalk are closed businesses. 15% of the country's 6.5m inhabitants are living abroad, in search of better opportunities.
Brazil. In October 2006, I was invited to chair a hedge fund conference on Latin America in Miami, and one thing I hear there time and again was that the Brazil story is "not just a commodity story", that there is high consumer demand, a developed and diverse industry and growing exports due to improved product quality. Brazil's power and future is its 188 million people. However, compared to other Latin American countries, Brazil seems to have the most challenges to educate them properly.

Latin America – the ultimate lesson

For me, the ultimate lesson that Latin America has taught me is that everything, also the wealth and power of nations, comes in cycles. On the Miami conference, I was talking with a Mexican fund manager and he said when he was young, people used the phrase "rich as an Argentinean" for a really wealthy person. Uruguay has fallen from a Swiss status into boring stagnation and even Brazil is a good example. From 1890 to 1920 the rubber boom brought immeasurable prosperity to the country, so that in Manaus, actually in the middle of the jungle, a opera house was built that is actually larger that the famous Garnier Opera in Paris. The best entertainers from Europe and North America were brought in for the pleasure of the 100 or so families that then controlled the economy of the area. The advent of synthetic rubber in the early 1920's brought an abrupt end to the party in the jungle. In my view, especially the "old" Europe may face a similar fate over the next decades.
Robert Shiller, one of the world's most renowned academic economists and a professor at America's Yale University, told the delegates at the 2007 Davos business summit that the rise of these twin economic powerhouses was "the greatest economic event since the Renaissance and the Industrial Revolution".
The Financial Times reported that Professor Shiller and other panellists sounded an ominous warning over the risk that a backlash across Western electorates could spark social unrest and a retreat by leading developed economies into protectionism. He called for governments to raise taxes on the wealthy to counter this danger, so that the proceeds could be used to ease the economic strains now afflicting large sections of Western societies and fostering increased inequality. "The political discourse about this problem is way too low," he added. "We really need in every major country a serious debate about how we are going to stop this inequality getting worse. And do it now, not after it has created all of these problems."
Shiller is focusing on the sociological and political consequences of economical downturns. Personally, I am pretty bearish on Europe in the long run. Another reason to start thinking about Latin America?

Matthias Knab is executive editor of Alternative Market Briefing published by Opalesque Ltd. (www.opalesque.com). Alternative Market Briefing is a premier international hedge fund news service reaching more than 44'000 professionals worldwide. Interested readers may use promotion code "swisshedge" for sizable discounts.

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Picture: Mexico City

Hedge Funds in Eastern Europe: A case study

By: Christoph Kampitsch, Mark Cachia,
Sonja Remetic I Erste Bank

Globalization has unleashed fast track economic convergence of the developed world and the countries which are considered to be in a transitional phase between developing and developed status. We have seen dramatically improved macro fundamentals, surging domestic spending, investor-friendly climate characterized by diversity, volatility, rapid economic growth and immature institutions. Being a key player in the Eastern European financial industry, we highlight the emerging regional hedge fund industry.

In the past 10 years, Eastern European Equities as measured by MSCI have increased over 800% in local currencies (roughly 25% pa). It is worth noting that this includes the Russia crisis of 1998 and the collapse of global equities in 2000. Just in case you might think this 10 year period was chosen out of convenience: looking further back to its launch (in January 1988) the index still shows annualised returns of 25%

Of course, this kind of retrospective investment deserves little applause. No doubt one can find any number of similar success stories; especially if one drills down to the individual markets or securities. However it does provide a context for us to understand valuations and hence the opportunities going forward.

Editors note: The Special Feature is designed to analyse a subject not directly related, but still relevant, to the rest of the magazine. We have chosen a leader in the Eastern European financial industry, and a seasoned investor in the hedge funds of the area, to provide an overview and short history of the eastern regional hedge fund landscape. The goal is twofold: First, to highlight the rapid changes and traits inherent to emerging markets. Second, Eastern Europe is particularly interesting as a case study, and perhaps roadmap, for Latin American hedge funds.

Convergence or converged?

The principal theme for Eastern Europe over the past decade has been one of convergence, much in the same way that Italy and Spain converged in the nineties. We see this trend continuing, but moving further East. Countries like the Czech Republic and Poland approach developed Europe in terms of Equity and Fixed Income valuations. Asset managers therefore have had to look further to find the sort of opportunities that were previously available. We are recently seeing funds concentrating on regions as far as the Baltic States or Central Asia where there is arguably greater economic optionality than in central Europe albeit within the constraints of barely traded equity markets.
To understand the opportunities within the wider region, one has to appreciate that central and Eastern Europe is highly heterogeneous. Although some ideas cross boundaries, many are expressed within individual countries.
The following sections hopefully shed some light on both the macro economic make-up of each, but also some of the more popular themes being captured by managers in each region.

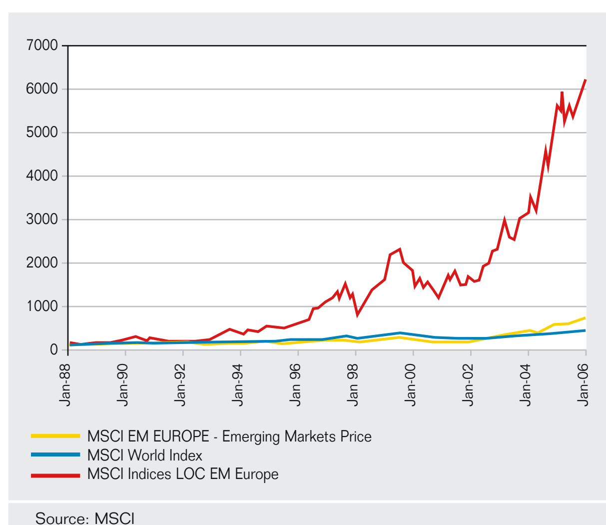
Focus: Eastern Europe

Eastern Europe, ranging from the Baltic to the Balkans, has been on fast reform track since the rise of the Iron Curtain. The countries under the Emerging Europe Umbrella benefited from their exclusive status as a play on joining the European Union and often outperformed the MSCI emerging markets index. Countries whose currencies are converging with the Euro are favoured – with Poland being on top of that list due to its tight ties to Germany and being one of the few foreign countries whose stocks trade on major exchanges in the US.
Being a direct link and a significant exporter to Western Europe and the Middle East, Turkey has been of major interest to many investors, especially those active in the banking and financials sectors. Kazakhstan has also received some attention this year due to the surging importance of oil.
Investors have seen a shift in buying attitude from initially purchasing Dollar- and Euro - denominated Eurobonds to allocating to local-currency government bonds by 2004. This change has been driven to a certain extent by the lack of sovereign external debt, which raised prices and pushed out the spreads that emerging market bonds offer over developed markets to multi-year lows. In 2006, the JPMorgan Emerging Market Bond Index has seen the lowest returns since 2001 (9.9% in 2006 vs. 9.7% in 2001). Central Europe continued to perform well, attracting mostly service industries, setting up regional centres on existent telecom infrastructure, transportation network, European Union Membership and cheap yet skilled labour force. Quite a few emerging economies hope to become not only the extended workbench of companies from high-wage countries but also their back-office. Surveys have showed that German companies are particularly interested in locating facilities in Central and Eastern Europe (CEE). The region is closer to the importers in time zone, physical distance and customer culture.

Hedge Funds and CEE

Russia and the CIS. Russia is the most populous country in the CEE and has the most hedge funds dedicated to it, with over 25 Russian hedge funds with offices in Moscow alone. Scores more are based in London and New York. While many of the larger funds are essentially long-only, or significantly long-biased, many of the smaller funds have more balanced portfolios and are traded opportunistically. Over the last several years, the Russian markets have been driven by booming energy and metals prices, and hedge

Figure 1 I EM Europe Performance



Source: MSCI

funds have benefited greatly from investing in that theme. Natural resource companies dominate the Russian Traded Index (52% Energy Sources, 12% Metals). As a result, long-only, buy-and-hold investors will continue to be at the mercy of energy prices when investing in Russia.

Hedge funds, on the other hand, have diversified their portfolios away from the energy complex. They are investing in themes such as the re-organization of the telecom and utilities industries and the rise of the middle class.

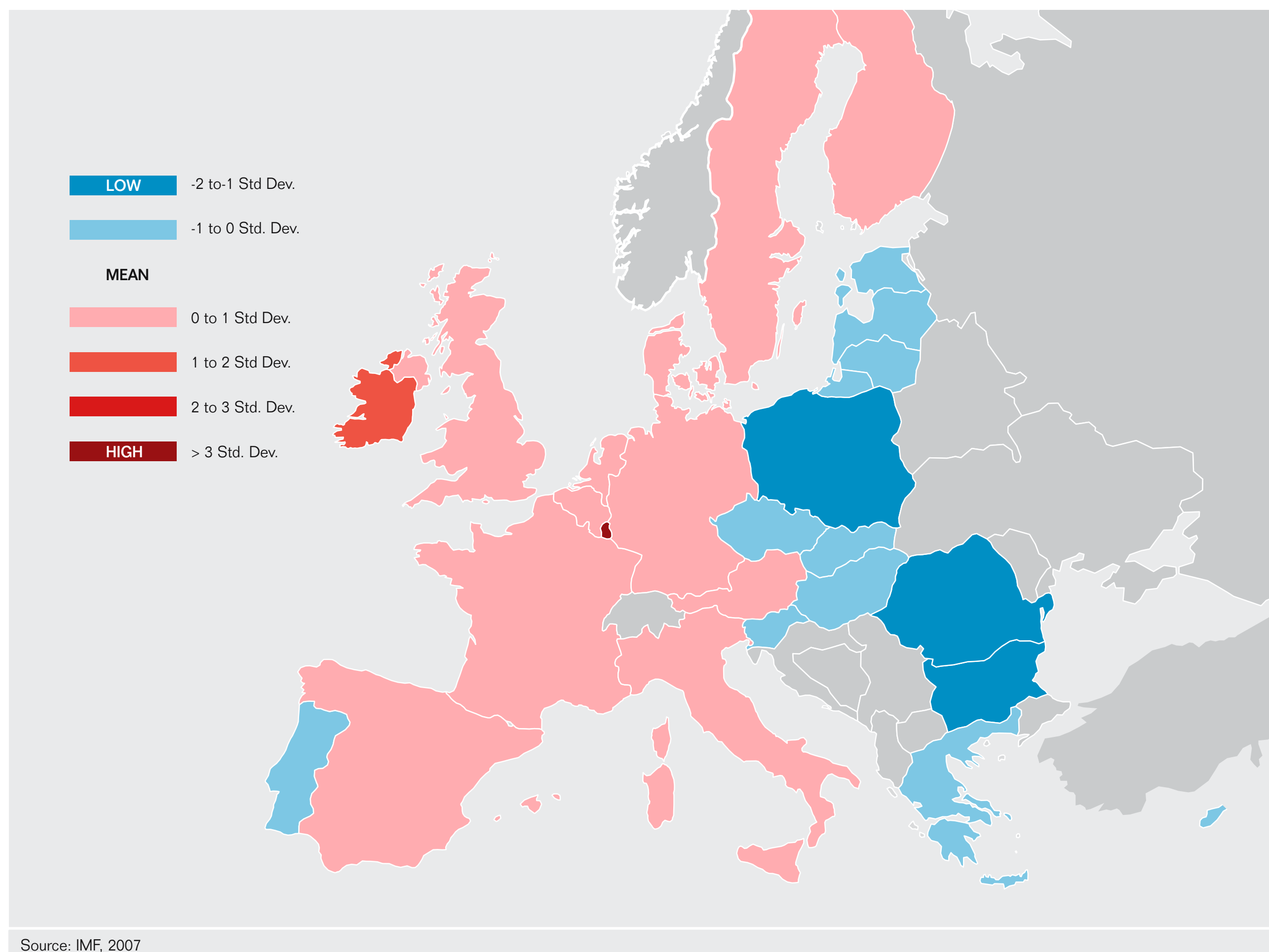
The rise of the middle class theme is popular throughout the CEE, and is expressed in several different strategies, from banking, real estate and construction, to retail. Hedge funds also are generally long the Russian Rouble, and expect continued appreciation over 2007. Managers expect significant volatility in the Russian markets as 2007 progresses due to uncertainty surrounding the elections and the question of succession of President Putin. Therefore, most plan to opportunistically trade around positions, mitigating risk and augmenting returns, an option that is not available to the behemoth long-only players and most mutual funds.

Hedge funds have also expanded out of Russia and into the CIS. Funds dedicated to the Ukraine and Kazakhstan have started in order to benefit from specific themes in those countries. As mentioned earlier, Kazakhstan has rapidly increased its production of oil and other natural resources, and will continue to do so. The financial sector and the capital markets are quickly expanding. Hedge funds are taking advantage of these events, aiding and abetting the emergence of Kazakhstan by providing capital, such as pre-IPO funding.

CE4 – Poland, Czech Republic,

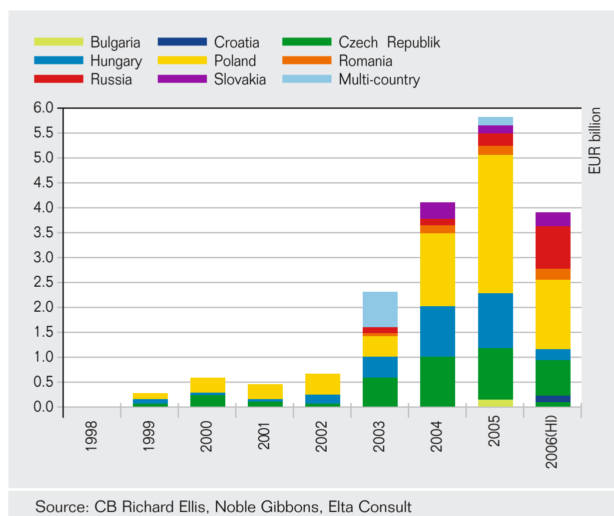
Hungary, Slovakia. The CE4 is the most mature region of the CEE. These countries are all part of the European Union and are at various stages of joining the EMU. Most of the convergence has played out, although some coun-

Figure 2 I European Union GDP (PPP) per capita



Source: IMF, 2007

Figure 3 I Anual CEE investment volume by country



Source: CB Richard Ellis, Noble Gibbons, Elta Consult

tries of the region (i.e. Hungary) have experienced more volatility than others. Hedge funds have benefited greatly from participating in the privatisation of formerly state-owned industries. Favourite positions have been companies such as CEZ, OTP Bank, and MOL, which were fabulously profitable (556%, 224%, and 239% respective 3 year performance), although not without risk (CEZ was down 35%, OTP was down 38%, and MOL was down 28% from their highs in April/May to their lows in June 2006, before rebounding and showing gains at the end of the year). Now that these companies are more fully valued, hedge funds have reduced long exposure to the region and are seeking to trade more opportunistically in the area. Fortunately, the Polish, Czech, and Hungarian markets offer index futures that are quite liquid that managers can utilize to gain short exposure to these markets. Managers also have expressed scepticism on the short term macro fundamentals of Hungary and the Czech Republic and have been incrementally adding short exposure to their currencies.

Turkey. After Russia, Turkey is the next most populous country under the classification of CEE. Not coincidentally, Turkey also has the second highest number of dedicated funds. Long-only investors were not rewarded in Turkey as they were in the other parts of the CEE, with the Istanbul ISE 100 Index declining nearly 3% for 2006 and closing the year down nearly 18% from the February highs. However, the greater flexibility of hedge funds has allowed them to avoid a portion of the downside in Turkish equities, fixed income and currency. While Turkey unquestionably has strong long-term fundamentals, the short term is likely to be fraught with volatility concerning the local political landscape, the EU question, budget deficits, inflation, and the current account deficit. Hedge funds enjoy the luxury of being able to trade both sides of a market that is very well known for its sudden, precipitous drops and its just as sudden, meteoric comebacks.

South-Eastern Europe. South-Eastern Europe, also known as the Balkans, has finally come into its own. The privatization process continues at various stages in the region. Even Slovenia, a member of the EU which adopted the Euro in January 2007, continues to privatize companies. These stock markets have performed tremendously well in 2006, with little participation in the May-June weakness that plagued others in the CEE. It is more difficult to short in this area, and the markets are also far less liquid than others in the CEE. Hedge funds have demonstrated their value by targeting companies that are likely to be acquired, thereby generating better than market average performance and participating in liquidity events.

The Baltic States. The Baltic States are the least populous and smallest geographically. As a result, they present the fewest investment opportunities for hedge funds. Many of the larger companies merged with international companies, leaving relatively few publicly traded opportunities. Consequently, hedge funds have been working in conjunction with private equity funds when investing in the market. While fewer opportunities exist in the Baltic States, the level of risk is also lower than the rest of the CEE.

Real Estate and the CEE

A fast-growing…In the first half-year 2006, CEE property markets continued their swift growth, driven mainly by high GDP growth and low penetration rates. The volume of property transactions in 1H06 reached EUR 3.9bn (+26% y/y). In 1H06, the majority of funds were invested in the core CEE markets of the Czech Republic, Hungary and Poland (79% of the total volume), but Russia is winning ground, accounting for 7% of overall investments. CB Richard Ellis expects a full-year 2006 property transaction volume of around EUR 7.0bn, not counting own development projects. With 65%, most of the current investments are still occurring in the capital cities. In terms of sectors, offices (43% of total volume) and retail assets (40% of total volume) are still dominant.

…and still attractive market. In addition to their high growth rates, CEE property markets also attract with decreasing yield levels, low vacancy rates and increasing rent levels. The convergence seen in recent years between the CEE markets and Western Europe in terms of yield

level is continuing. In the core CEE markets, convergence is losing speed, although emerging markets still show room for further compression. Despite a strong increase of available office stock, vacancy rates in the CEE region are stabilizing after declines in the last few years. Aside from the yield level, the rent itself is the second factor contributing to the value of a property. As a consequence of the rather stable development in vacancy levels, rents have also remained nearly unchanged. Moscow is the exception, as we have seen consistent rental growth over the last few quarters there. According to Jones Lang LaSalle's European Office Property Clock (which shows the expected change of absolute rent levels in prime locations within each market), most CEE cities are either in the phase of bottoming out (Prague, Vienna), or have already entered a phase of rental growth (Budapest, Warsaw). Moscow

Figure 4 I Local statistics

	Population	GDP (PPP) millions of int.dollars	GDP (PPP) per capital int.	GDP (nominal) per capital int.dollars	Percentage of EU average GDP (PPP) per capital
European Union	485.703.094	13,840,833	27,894	30,937	100%
Luxembourg	448.569	35,194	76,025	91,927	273%
Ireland	3.883.159	191,694	45,135	57,163	162%
Denmark	5.368.854	203,502	37,399	54,474	134%
Austria	8.169.929	298,683	36,189	41,266	130%
Finland	5.157.537	179,141	34,162	41,542	122%
Belgium	10.274.595	353,326	33,908	39,331	122%
Netherlands	16.318.199	549,674	33,079	42,763	119%
United Kingdom	60.201.000	2,004,461	32,949	41,960	118%
Germany	83.251.851	2,698,694	32,684	36,779	117%
Sweden	9.090.113	296,715	32,548	44,454	117%
France	59.765.983	1,988,171	31,377	37,417	112%
Italy	58.751.711	1,791,006	30,383	33,078	109%
Spain	40.007.100	1,203,404	28,810	31,727	103%
Greece	10.645.343	274,493	24,733	24,030	89%
Slovenia	1.932.917	49,062	24,459	18,346	88%
Cyprus	802.000	19,692	23,419	22,046	84%
Malta	397.499	8,447	21,081	14,598	76%
Portugal	10.084.245	217,892	20,673	19,000	74%
Czech Republic	10.256.760	210,418	20,539	15,186	74%
Estonia	1.415.681	25,796	19,243	12,933	69%
Hungary	10.075.034	190,343	18,922	10,914	68%
Slovakia	5.422.366	101,220	18,705	11,307	67%
Lithuania	3.601.138	56,985	16,756	9,620	60%
Latvia	2.366.515	34,426	15,061	10,074	54%
Poland	38.625.478	556,933	14,609	9,214	52%
Bulgaria	7.621.337	82,533	10,844	4,075	39%
Romania	21.698.181	218,926	10,152	6,338	36%
Candidate countries					
Croatia	5.654.200	61,804	13,923	10,559	50%
Turkey	72.600.000	653,298	8,839	5,417	32%
Republic of Macedonia	2.054.800	17.902	8,738	3,040	31%
Potential Candidate Countries					
Bosnia and Herzegovina	3.964.388	25,505	6,884	2,774	25%
Albania	3.544.841	18,329	6,259	3,175	22%
Serbia	9.663.742	51,162	6,112	3,700	22%
Montenegro	616.258	2,412	3,800	1,784	14%

should see rental growth slowing down - after significant growth in the last few quarters.

Conclusion

The best way to understand any asset class, a market or a region is by studying it intensively, have some "real" exposure there (not just on paper) and people with long expertise in the local market. In case of investing in hedge funds in Central and Eastern Europe (the same is of course true for Latin America or any other emerging market) one must travel within the region extensively, talk to the right people (speaking their language helps a lot) and find the local investment talent. One cannot just search databases to find the right managers or open a specialised magazine to read about the local hedge funds.

On top of what is outlined in the editors note we want to highlight two more things: Firstly, share some of our insights in this region with the readers and secondly, show the advantage of finding the right managers, in this case someone has who is as anchored there as the Alternative Investment Team of Erste Bank.

Picture: Buenos Aires

Roundtable discussion

swissHEDGE regularly invites reputed hedge funds to a discussion on their area of expertise. This time, we have invited three prominent Latin American hedge funds to share their views on the local investment environment.

Maua Investimentos

Maua Investimentos

Fund:	Maua Brazil Fund
Representative:	Luiz Fernando Figueiredo, President of the Investment Committee
AUM:	USD923m

Copernico Capital Partners Ltd

Fund:	Copernico Latin America Strategic
Representative:	Ricardo S. Maxit, Portfolio Manager
Firm AUM:	USD290m

Greylock Capital Management, LLC

Fund:	Greylock Emerging Market Equity
Representative:	Lucia Skwarek, Portfolio Manager
Firm AUM:	USD800m

Q: Why is Latin America attractive for hedge fund investing ?

MAUA: Latin American countries have gone through an adjustment of their external accounts – helped by a benign global environment – that has strongly reduced solvency risk across the region. On top of that, most countries adopted prudent fiscal policies as their main macroeconomic framework. These factors allowed for a deepening of local markets in the region, especially as external debt has been reduced drastically. Markets became more liquid, the duration of domestic debt has increased markedly, and appetite of foreign institutional investors is at all-time highs.

COPERNICO: The region offers positive secular trends with sharp cycles. In the last few years, macro stability and improved credit quality in some countries have allowed for long-term investments. Moreover, we are in a corporate environment of increased consolidation amongst a backdrop of players that in many cases are forced to take non-economic decisions due to market and resources constraints. In the last 18-24 months, fundamentals have improved substantially. Asset prices followed suit. Therefore, it is harder to find clear investment opportunities in the most liquid and crowded markets. However, we believe that today there is an opportunity to go down the liquidity spectrum by investing in both public and private assets that are less correlated with the market.

GREYLOCK: As the countries become more open and corporate governance improves, hedge fund-style investing becomes easier every year. For the larger countries, there are a number of ways to go short, via indices or futures locally, or via ADRs listed in New York. There are also different pools of investors who might take very different valuation views on a particular company – from local investors to professional emerging market investors to global investors. Valuations are attractive as lower interest rates, lower inflation and lower political volatility make projecting economic and company performance easier than ever before.

Q: What is your macro economic outlook for Latin America as a whole? How relevant is the macro environment to the management of your fund?

MAUA: Despite much sounder external accounts and reduced dependence on external financing, most Latin American countries rely deeply on the positive global scenario and supportive commodity prices. Hence, should there be a severe downturn on global economy (especially in the US and China), the region will suffer. We do not expect such a reversal for 2007. A softer, more balanced global economy should be seen as positive for the region. One should keep in mind that the shift of some countries to populism with prudent fiscal policy is worrisome, especially in light of softer commodity prices.

COPERNICO: Macro is of high importance for us, since Fed decisions or abrupt liquidity contractions can affect asset pricing considerably. However, the bottom-up approach is even more important as we tend to have several stories in the portfolio which have a low correlation with the market, and that are mainly driven by specific catalysts. We believe the macro economic outlook for Latin America to be a good one for 2007. Liquidity will remain high, and stable if not surging commodity prices will make a great setting for the region. Also, there is a growing consensus that Fed Funds will remain at these levels, contributing to a favorable environment for global emerging markets.

GREYLOCK: The Macro environment for Latin America has always been key for any manager. For us, the macro environment drives our country allocation decision, and then the actual stock picking is driven by valuation. Buying cheap stocks in improving economies should always outperform those in deteriorating economies. The “country call” always matters as the variety and frequency of Latin American crisis can remind us. But the macro view is not just important for foreign investors, it is extremely important for local ones as well. One of the reasons that reserves have been built is because local investors are comfortable investing in their home countries for the first time in years. Historically, the busts were driven by local capital fleeing the country at the first sign of instability. Peru is a good example of how local investors, not foreign ones, have been able to build up investment in the country for the first time in decades. Our macro outlook is that the big countries, Brazil and Mexico, have solid macro foundations now, with very low risk of backtracking to old-style policies. Venezuela and Argentina however, are more complicated, with a higher risk of inflation, political problems, etc.

Q: To what degree is “being local” a competitive advantage?

MAUA: As the markets get more breadth and become more developed, local issues should start to dominate risk appetite. In the last 10 years, the relevance of global themes over local themes has been obvious, but we expect this pattern to reverse going forward. On the equity market, it seems that being physically close to the companies helps our research capabilities and improves our understanding of earnings.

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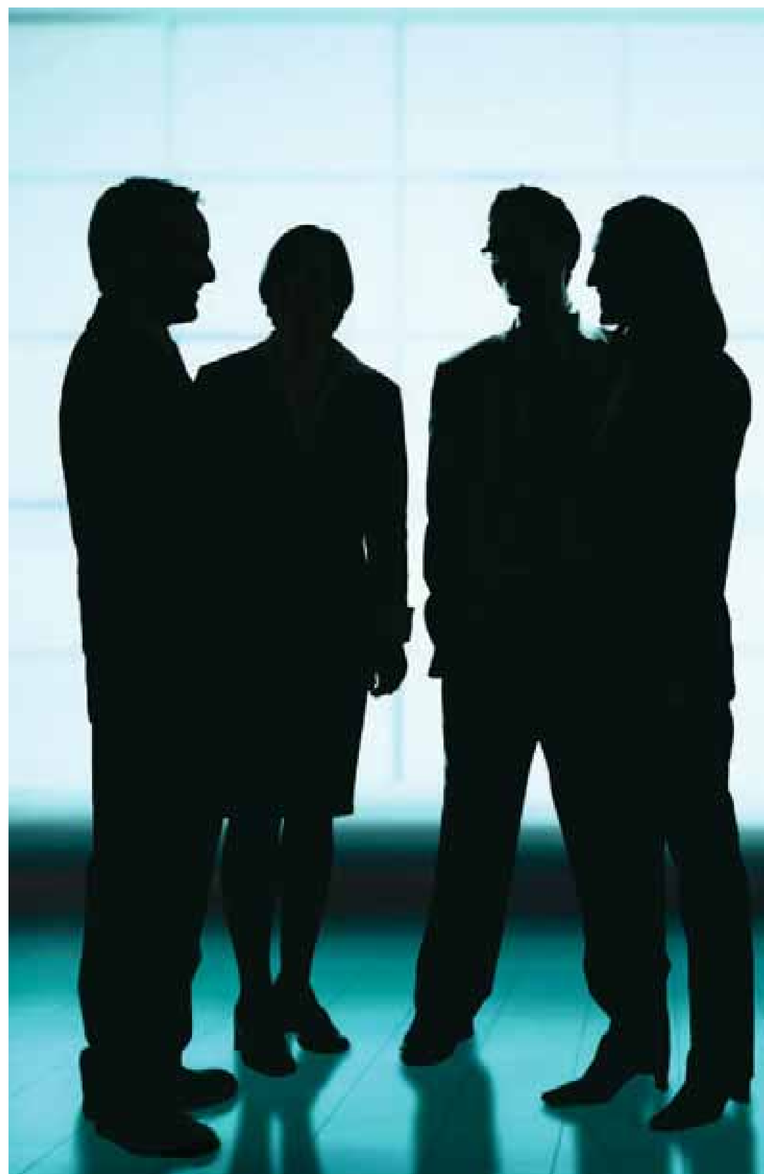
COPERNICO: For most liquid assets, trading in the region has become a commodity. For this type of investment strategy, we believe that the advantage of being local has diminished. However, there are some other opportunities more related to credit or special investments where we believe that being local provides an edge and gives more access to certain deals where locals are always the first call.
GREYLOCK: Being local can be both a curse and a blessing. It can be a curse as you can get "too native" and lose your objectivity and lose sight of what global markets are doing. It can be a blessing because you will have a good idea of what local investors are thinking and feeling. But Latin America is a big place, and each country is different. So, a Brazilian trading Mexico from Sao Paolo is no more local than someone sitting in New York. I do think it will be useful for an organization with local people on the ground in each country. It is also useful for small and medium cap strategies, as well as accessing local investor flow from the growing pension funds.

Q: What are some of the unique and interesting investing opportunities that are available in Latin America?
MAUA: Our top pick is the equity market in Brazil. As we expect real interest rates to continue to drift lower, the equity market is supposed to increase both in valuation and in number of listed companies. In addition, local investors hold very little of equity on their portfolios, and a shift should be expected during the next 5 to 10 years. Consumer credit in Brazil is another market that has increased over the past couple of years, and we expect this pattern to intensify going forward.
COPERNICO: There are plenty of examples such as factoring in Brazil, Argentina, Mexico and Uruguay; refinancing and restructuring stories in Mexico and Argentina; and interest rate swaps in Brazil betting on a drop of medium-term rates. While there will be a few macro plays, it won't be as exciting as previous years, as micro stories in general will be the main investment themes for the next 1-2 years.
GREYLOCK: Infrastructure in Brazil could be an exciting theme over the next years. Brazil has been building up reserves, expanding payments of social services, but doing very little to invest in its inefficient and aging infrastructure such as roads and railways. In Mexico, any opening of the electricity or energy sector too will be interesting. Chilean companies that do business in Argentina are interesting as well, as those assets have been considered nearly worthless since the crisis, but they today have enormous recovery potential.



Q: How important are the global economies to Latin America? Which ones have the most pronounced impact and why?
MAUA: The relevance of global economies to Latin America is still notable, but we do expect it to decline over the next 5 years. US and China are definitely the most relevant, especially in light of commodity prices. It is worth noting that, given the improvement on the solvency of the region, the impact of reduced liquidity and/or lower commodity prices is smaller today than it was 5 years ago.
COPERNICO: Global economies are very important to Latin America, since they are the liquidity providers and at the same time very important commodity buyers, especially of soft commodities. US, Europe, China and India are the most important global economies that have a significant

impact in Latin America.

GREYLOCK: The health of the global economy is important to every Latin American economy. The reserve build up has been due to global growth spurring commodity and manufacturing exports and rising global liquidity. Not even a closed economy like Venezuela's is immune to a slowdown in global growth. The US and China are probably the economies with the most impact on Latin America. China's growth has increased commodity demand globally, and puts Brazil at risk should that growth slow. Mexico is particularly sensitive to US growth and will suffer if US growth is below expectations. That being said, there is a lot that countries can do in order to insulate themselves from a downturn in global growth by instituting reforms on labor, pensions and taxation.

Q: Given that Brazil is the largest economy in South America, what other countries present investment opportunities? Why?

MAUA: Mexico, Chile and Colombia are the other countries were we see good opportunities. These markets have good liquidity (especially Mexico) and their governments have shown respect to contracts and orthodox policies; they present a stable macroeconomic framework.

COPERNICO: Besides Brazil, we believe that Mexico, Chile and Argentina are the other main investment markets in the region. All these countries provide relevant opportunities due to improving local economies, booming commodity markets and massive inflows of funds for all emerging markets. Additionally, there are a number of countries that provided very interesting opportunities in the past and we are certain that they will continue to do so in the future. Some of them are Venezuela, Dominican Republic and Uruguay.

GREYLOCK: Mexico, in terms of the stock market, is at the top of being reasonably priced. Argentina could be quite interesting if the growth could be harnessed into new investments. Earnings recovery continues in Argentina and the companies are quite adept at maneuvering around the government controls. Peru is interesting as well, as domestic demand should continue to grow, but the market seems quite expensive. Chile is a country I like a lot, as valuations seem reasonable if you look beyond p/e's which are often distorted due to accounting differences with the rest of Latin America. Also, Chile is a good "port in the storm" should the rest of the region trade down.

Q: What do you see as major risks in investing in Latin America? What do you consider as the single most risk?

MAUA: The shift of some countries into populist-like governments is the single most important risk. These governments have been acting on a market-friendly way, but we're not so certain that they will react accordingly should there be a correction on commodity prices and a reversion on risk appetite over the next 12 months.

COPERNICO: We believe some risks are: liquidity, inflation and economy growth concerns in the US that can cause further moves in interest rates there, local currencies weakening vis a vis to the US dollar, a sharp fall in commodity prices–especially those actively traded in Latin America–and a deterioration of fundamentals in the region. We believe one of the most important risks in the short to medium term is a reduction in global investor liquidity, since it would affect asset pricing and could force

some capital calls in Latin American asset managers. Besides this short-term risk, we believe that inflation and economic growth concerns in developed markets, especially in the US, are a major risk. It is worth mentioning that today Latin American markets are better prepared to handle external events as the ones mentioned above, due to improved fundamentals across the board.

GREYLOCK: The single most risk: lack of reform. The poor people in these countries have been very patient waiting for the global growth to trickle down to them in the form of better education, better jobs, less corruption, etc. If there is no progress soon, you may see situations like Venezuela, Ecuador, Bolivia, where old-style populism is attractive once again. Both Mexico and Peru were extremely close calls – Mexico but for the lack of 20,000 votes could have seen a very different political landscape than today.

Q: There have been frequent market crisis in emerging markets, particularly Latin America. Why is Latin America prone to such events and do you see one on the horizon?

MAUA: In the past, Latin American countries have had very weak debt profile, high dependency on external financing and commodities were on a bear market. This situation started to reverse by late 2002, after China entered the WTO. Today, most countries in the region have close to zero dollar denominated debt, issue in domestic currency on the offshore markets, have increase their foreign reserves, and maintain a prudent fiscal policy. It is fair to say that the causes of crisis in the past have been drastically reduced, that sudden stops in external financing are no longer a risk and that these countries are in a much better shape to withstand market turmoil or a change on the benign global environment. Nevertheless, we are particularly cautious on the marked shift towards populism and potential impacts on the market friendly policies adopted so far. It is noticeable that the region presents a rate of growth much lower than other emerging regions. The temptation to promote more short-term growth might jeopardize the good work that has been done so far.

COPERNICO: Latin America has suffered frequent market crises in the past, which we believe have been due to a combination of factors such as poor fiscal policies, lack of structural reforms, fixed exchange rates, and infrastructure investments driven by market cycles rather than economic cycles. We believe that in the medium-term horizon, while a crisis can happen again, it is very unlikely that it will have the strength of previous regional crises such as Mexico's 1994, Brazil's 1999 and Argentina's 2002.

GREYLOCK: Latin America continues to have too many poor people and just a very few rich people. The lack of political/judicial and social infrastructure leads to corrup-

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tion that the governments can't stop even when they want to, as evidenced by the level of crime in Mexico and scandals in Brazil. The lack of confidence in the government leads to a run on the currency and distrust of investors. I don't see a crisis brewing in any particular big country on the horizon, but again, investment in the poor population's well being must begin to occur soon or we will be confronting that kind of crisis again.

Q: What sort of specific knowledge should investors have to invest in Latin American hedge fund managers?

MAUA: Despite the good performance of most assets on the region over the past 3 years, investors should be aware that volatility is a relevant variable and that liquidity – even though much higher today than 3 years ago – is still an issue when markets get shaky. In addition, there has been an increase in duration on most local interest rate markets, which should add volatility on corrections.

COPERNICO: Besides the standard due-diligence process that an investor must conduct with any hedge fund manager in the world, we believe that they should also understand the local hedge fund manager's real edge in the region, and what separates that specific manager from all others in terms of deal sourcing and risk-adjusted returns.

GREYLOCK: History. It is extremely important to know where these countries have been to understand where they are today and how they are going to have to change in the future.

Q: How do you see the Latin American hedge fund industry evolving in the next 2 to 3 years?

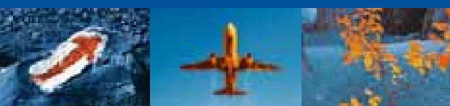
MAUA: The fund industry in Brazil is the most developed on the region and we believe it will continue this way over the next couple of years. Local hedge funds will become the major risk-takers, as there should be a shift on portfolio allocation of individuals, from mutual funds into hedge funds (macro and equity hedge funds). We firmly believe that the equity market's relevance will increase and that local players should be prepared for this shift.

COPERNICO: Right now there are approximately 130 Latin American offshore funds that are based in Latin America. The lion's share of them is based in Brazil, with a few in Argentina and close to none in Mexico and Chile. A majority of these funds focus only on Brazil, mainly due to their geographical location. Besides these funds, there are also a number of managers located in the US and Europe that have a portion of their funds dedicated to Latin American assets.
In the next 2-3 years we think that more than a few players based in the region will emerge (in 2006 we have seen some of them settling in different countries of the region), but with renewed competition coming from US and European managers who are likely to broaden their Latin American strategy as part of their investment mandate. Moreover, a specialization in the region is going to take place, with new niche-markets and standardized asset classes. This will generate more competition in the medium-term.

GREYLOCK: It is evolving into a market where the investor base is no longer exclusively international. The professional local investor base will grow, deepening the capital markets. That local investor base will require the same sort of products that investors in developed countries demand, such as hedged investing, derivatives and structured products. The companies themselves will continue to access capital and broaden their ownership, so there will be more stocks available and more industries will develop. I can imagine new sectors such as health care and transportation emerging.

HARCOURT EVENTS 2007

Event	City		Date	Venue	Time
Quarterly HF Presentations May	Geneva:		09	Hôtel Mandarin Oriental	08.30-10.00
	Stockholm:		10	Operakällaren	08.30-10.00
	Zurich:		11	Haus zum Rüden	08.30-10.00
Quarterly HF Presentations September	Milan:		03	Hotel Excelsior-Gallia	12.30-14.00
	Lugano:		04	Hotel Dante Center	08.30-10.00
	Geneva:		05	Hôtel Mandarin Oriental	08.30-10.00
	Paris:		06	Hôtel George V	09.00-10.30
	Zurich:		07	Haus zum Rüden	08.30-10.00
	Frankfurt:		10	Hessischer Hof	12.30-14.00
	Amsterdam:		11	Amstel Hotel	08.30-10.00
	Copenhagen:		12	Nykredit Offices	08.30-10.00
	Stockholm:		13	Operakällaren	08.30-10.00
	Madrid:		11	Hotel AC Cuzco	09.00-10.30
	Barcelona:		12	AC Irla Hotel	09.00-10.30
8th Annual Hedge Fund Seminar	Flims	Oct.	03 - 05		



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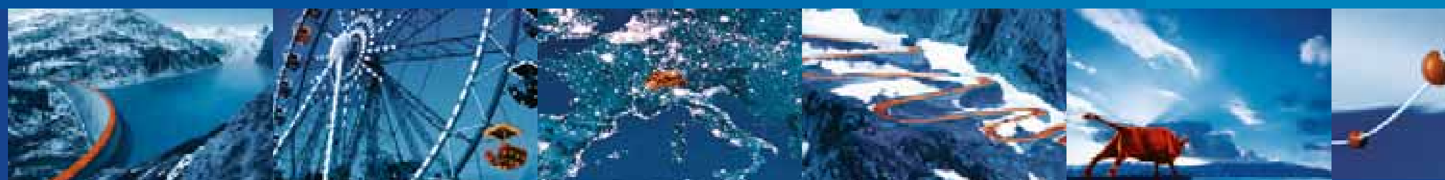

Upcoming conferences 2007

Month	Date	Conference
February	12 - 14	**Hedge Fund Replication & Alternative Beta** The Landmark, London, United Kingdom www.terrapinn.com/2007/altbeta/
	Feb. 28 - March 2	**Hedge Funds World Australia** The Westin, Sidney, Australia www.hedgefundsworld.com/2007/hfw_au/confprog.stm
March	12 - 13	**SuperHedge 2007** Congress Center, Frankfurt, Germany www.worldhedgefundssummit.com
	13 - 15	**Managed Accounts USA** The Embassy Suites Hotel, New York, USA www.hedgefundsworld.com/2007/mausa/

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