

Investing in Emerging Markets

LOUIS C. GERKEN, GERKEN CAPITAL ASSOCIATES



LOUIS C. GERKEN, Founder, Chairman and CEO of Gerken Capital Associates (GCA), has been active in the alternative investment business since the mid-1970s. Prior to forming GCA, Mr. Gerken was a Managing Director and Group Head of Prudential Securities Technology Investment Banking Division. The group served as advisor to over 30 M&A and corporate finance mandates exceeding \$4.5 billion in total financing.

Clients included British Telecom, Hong Kong Telecom and Bell South. Earlier, Mr. Gerken was a General Partner to Prudential Securities' four venture capital funds with \$336 million under management. As one of the largest VC funds, it was responsible for completing 50 IT and biotech sector early and expansion stage investments, and was one of the first VC funds to pioneer corporate partnering as a co-investment strategy. Mr. Gerken had Board of Director and/or portfolio responsibility for Ecogen, Summit Technologies, Boston Scientific, Marquest Medical, Masstron, Visiontech, Crystal Diagnostics, LaPine Technologies, Navtech, Plexus Computers, American Software, and Tridon. Prior to his tenure at Prudential, Mr. Gerken was associated with Montgomery Securities' Venture Capital Funds, and Wells Fargo Capital Markets, where he developed one of the first US funds of funds. Earlier in his career, Mr. Gerken was President of TCG International, a telecommunications consulting engineering practice responsible for the deployment of over 60 international projects. The firm was successfully sold to Price Waterhouse. Prior to that he was a Senior Research Analyst and Portfolio Manager with GT Capital Management, an emerging markets investment management firm, and was an Investment Officer and Research Analyst following the technology and financial sectors with the Bank of California. Mr. Gerken is a prior Chairman of the Film Institute of Northern California. He received an MBA from the Southern Methodist University Graduate School of Business, a Master's degree in International Business from the American Graduate School, and was awarded a Bachelor's degree in Economics from the University of Redlands. He is a frequent speaker and writer on alternative asset investments. Series 7, 24 and 63 licenses are held by Mr. Gerken.

SECTOR – GENERAL INVESTING

(ZGB501) TWST: We are looking forward to finding out how the Greater China market is doing and the differences with what it is over here, but would you start with a brief overview of your firm?

Mr. Gerken: GCA is an alternative asset fund manager with a primary focus on the emerging markets. We manage and advise \$1.3 billion in AUM and I serve as the Group CIO. Our client base is primarily institutional, both US and offshore. The firm was established in 1989 and we are a San Francisco Bay Area-based

firm. We are registered investment advisors. We have 10 investment professionals and the firm is 85% employee-owned.

Our investment platform and team skill set leverages three major paradigm shifts that very much work to our favor. First is the transition of long-only oriented investment portfolios to include the alternative asset classes that began in the early 1980s but are still very prevalent today. Second is the importance of small to mid-sized, employee-owned asset management firms in generating superior investment results for investors. Most large asset management firms are excellent at gathering assets, have very established and capital intensive infrastructures, e.g., risk management, and are aggressively moving toward open architectures where they select the better performing investment firms for their client base. Third has been the transition of the emerging markets to emerged markets and the hand-in-hand capital flows of G7 FDI and FII into these markets. Collectively, these paradigm shifts are not short-term phenomena but rather the early stages of the "efficient frontier" for managing capital looking forward.

"Our investment strategy is strategically designated as multi-asset, multi-strategy. This is significant, given that the emerging markets are growing very fast and rapidly playing catch up with G7 standards for transparency and availability of financial instruments and products."

Our alternative asset platform consists of both single manager hedge funds and a private equity fund-of-funds business. For our hedge funds, we have a BVI-based master-feeder platform called GCA Funds Limited. It has five segregated share classes, each representing a designated emerging market and each positioned as a multi-strategy fund. GCA Greater China was launched in 2005 and we launched our Latin America Fund in 2007. Looking forward we are hopeful to launch our Greater India and Greater Russia funds this year, and our Middle East fund the beginning of next year.

With our completed emerging markets hedge fund investment platform, investors have the ability to invest in one or any combi-

nation of the underlying funds and can also rotationally trade between the share classes monthly. From the perspective of our portfolio managers, it provides us with the added alpha differentiator of being able to spot cross-BRIC investment opportunities that wouldn't necessarily be the focus of a region-specific fund. We think this is a tremendously underserved segment of the market, given the growing levels of cross-BRIC FDI capital flows, and capable of generating some exciting investment opportunities.

Highlights

Louis C. Gerken says his investment approach is multi-asset and multi-strategy. Since he operates in fast growing, equity long-short bias markets in the medium to long term, it is essential to have the skill set and flexibility to manage capital dynamically across various asset classes as they develop in the underlying regions. His objective is not to hit home runs, but rather to hit a series of consistent hits matched with soft landings when there are corrections in the markets. He selects small to mid-sized, independently owned asset management firms. He identifies the best regional investment firm to become GCA's long-term and exclusive affiliate. He looks for the local emerging market partners for their embedded risk management and ground research presence. Severe market corrections create contagion and he feels that the contagion impact results in attractive regional valuations. He looks at this as an excellent buying opportunity where, of course, the key question is investment timing. He thinks we are at or near that point in the US and that it's now a good time to allocate dollars back into the market. The difference now is that alpha is most important in being able to discriminate about what you own rather than merely benefiting from investing in a rising tide market.

capital across the various asset classes as they develop in the underlying regions. Anecdotally, Taiwan, Brazil and Mexico barely had equity derivative markets five years ago and today rank third, fifth and seventh globally. As such, we don't want to have the best equity long short team focusing on China to find out that 2008's P&L attributes come December came from a mix of other asset classes and investment products. Therefore, our approach requires us to take a top-down view where we optimize the underlying asset allocation mix to capitalize on the prevailing investment climate.

Our second area of differentiation is our return profile. In a world of 10,000 hedge funds that are all "top quartile performers," our objective is not to hit the ball out of the park, but rather to hit a series of consistent base hits matched with soft landings when there are corrections in the markets. By way of example, our Greater China Fund has been up or flat in seven market downturns since inception in 2005. We think superior performance is not measured by a fund's ability to generate returns, particularly when the tide is rising (medium to long term rising), but how the funds do during periods of market downturn. Also important is how the managers perform during extreme periods of panic when there is blood on the streets.

GCA's last major differentiator is our structure. This is always a challenge to communicate because listeners always inherently shy away from something that is not the norm. That said, I mentioned early on the importance of selecting small to mid-sized, independently owned asset management firms. Their investment performance by and large is superior to the large investment firms for a host of reasons, not the least of which is "skin in the game." These owner-operated firms feel the investment return "pains and gains" of their investors and therefore their economic interests are truly aligned — and this is imperative. The Achilles heel in this is that despite their best intentions, small to mid-sized firms do not possess the balance sheets of their larger firm counterparts where infrastructure requirements, particularly risk management, are very capital-intensive line items, not just to implement but to maintain thereafter. This is the primary source of operating risk that faces emerging managers and moreover in the emerging markets with their very fast growth and moving parts.

"GCA's approach is to marry the best of both worlds by way of judiciously identifying 'the right' regional investment firm to become its long-term and exclusive affiliate. Here we look to our local emerging market partners for their embedded risk management and mid-office infrastructure and for their ground research presence, which is most important in direct meetings with small to mid-cap companies that drive 50% of emerging market GDP growth."

GCA's approach is to marry the best of both worlds by way of judiciously identifying "the right" regional investment firm to become its long-term and exclusive affiliate. Here we look to our local emerging market partners for their embedded risk management and mid-office infrastructure and for their ground research presence, which is most important in direct meetings with small to mid-cap companies that drive 50% of emerging market GDP growth. Here, we spend the majority of our time with regional partners' pre-fund launch in ensuring that their investment, risk management and operating platforms are fully integrated with our AIMA sound practices.

For each fund, GCA has a 100% dedicated PA and Associate PM. The PM typically co-offices with the regional affiliate and has full portfolio investment authority. The Associate PMs are all based in San Francisco where they act as back-up PM, provide research ideas to the PM and jointly collaborate in generating cross-BRIC investment ideas.

The Polaris Group, Taiwan's largest listed investment house, is our Greater China Fund Affiliate Partner. BBVA, the largest asset management firm in Latin America, is our GCA Latam partner. The byproduct of this structure is that we typically launch our funds with the largest on-the-ground invest-

ment team serving the market and with the embedded infrastructure to scale AUM uninterrupted by the operating risks facing most emerging managers, particularly in the emerging markets.

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The final result or end game of this three-point differentiation is to position ourselves as an institutional grade management team. Our view is that superior investment results are at best temporary if you cannot withstand the test of time. We also think this very relevant in that the world does not need 10,000 hedge funds and that there will undoubtedly be a material consolidation in the space, which is not necessarily a bad thing given a no barrier to entry business.

Very briefly, our private equity business is a fund of funds business only. Principals at GCA launched their first fund back in 1981 (candidly, not even knowing that it was a fund of funds) and we launched our most recent in 2001. This will be our sixth fund and we propose to complete our initial close in 2008. The fund will be 100% emerging-markets focused and reserve 20% for related co-investments and secondary investments. We are presently talking with select parties interested in an anchor/sponsor role in the fund. We seek to raise \$300 million in capital commitments for the fund. We look very favorably on the prospects for the fund, given our view that the vintage period of investment will match nicely with our outlook for private equity investing in the emerging markets.

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TWST: What is the impact of the turbulent times in the market and the slowdown of the US economy on these international markets and how does that affect your investment?

Mr. Gerken: There is no doubt that severe market corrections, wherever their origins, create contagion leading to 1.0 correlation. One can easily witness capital flows moving in and out of regions very quickly. That said, as these emerging markets have become emerged markets, they are rapidly attracting a larger base of long-term institutional investors who dampen the impact of the historic short-term “flippers” in the region. In addition, although the G7 markets are still large in absolute terms, they are being rapidly displaced by the faster growing emerging markets as the global market leaders, who are decoupling as they have their own respective set of domestic drivers. Most recently, the sub-prime crisis proves this out in that many of the emerging market sectors and companies have had little effect felt on their respective EBITDA growth. Nevertheless, the contagion impact has been felt and resulted in attractive regional valuations. We look at this as an attractive buying opportunity where, of course, the key question is investment timing — how far does the knife continue to drop before you are able to see a turn in the market?

“By and large the consumer sector with improving household incomes and low penetration rates, record infrastructure and construction spending on behalf of government, and financial services sectors are very attractive. That said, it is critical to understand that the domestic drivers vary considerably country by country. These sectors will diversify the emerging market economies that have historically been dependent on the export of low cost exports and commodities.”

Our view is that we are at or near that point and that it's becoming a very good time to allocate dollars back into the market. The difference now is that alpha is most important in being able to discriminate about what you own rather than simply benefiting from investing in a rising tide market.

TWST: How important is it, though, to have partners like Polaris and BBVA that are on the ground, so to speak?

Mr. Gerken: Obviously, since it's inherently part of our structural DNA, we think it very important. This includes being able to access the under-researched small to mid-cap sector and IPO and pre-IPO opportunities, being able to dramatically improve the quality of investment decisions we make, and being able to really understand the respective domestic drivers for the various underlying countries in the region we serve and importantly how they interact to create investment opportunities. You have to be on the ground and have the requisite infrastructure to be able to act on it.

TWST: Do you hedge your currency risks in the Funds?

Mr. Gerken: We can, but we haven't. In general, our view has been that the markets we serve have and will continue to have appreciating currencies versus the US dollar. Nevertheless, the skill set and instruments are available if we take a different view.

“Our medium- to long-term outlook for the Greater China and Latam regions is quite positive, with 8%-9% GDP growth for China and 4%-6% for Latam. Although rising in the first half of 2008, we anticipate manageable levels of inflation and unemployment, given the soundness of emerging market government balance sheets and their inherent flexibility to react.”

TWST: Would you give us your outlook for the different regions in which you invest for 2008?

Mr. Gerken: Our medium- to long-term outlook for the Greater China and Latam regions is quite positive, with 8%-9% GDP growth for China and 4%-6% for Latam. Although rising in the first half of 2008, we anticipate manageable levels of inflation and unemployment, given the soundness of emerging market government balance sheets and their inherent flexibility to react.

We believe the 2008 investment climate and beyond will be different in that “rising tide” investing of the past several years is all but over, as emerging market companies have reached valuation levels of their global peers, and where asset managers must now be active in managing portfolios and discriminating in what they buy and sell, putting the premium on alpha.

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TWST: What are the sectors where you are finding growth in these markets?

Mr. Gerken: By and large the consumer sector with improving household incomes and low penetration rates, record infrastructure and construction spending on behalf of government, and financial services sectors are very attractive. That said, it is critical to understand that the domestic drivers vary considerably country by country. These sectors will diversify the emerging market economies that have historically been dependent on the export of low cost exports and commodities. In Mexico for example, 85% of exports go to the United States alone. One would logically conclude that with the prevailing slowdown in the US economy and in construc-

tion and housing in particular, that this would have an exponential impact on Mexico. In fact, the result has been just the opposite, reflecting the Mexican government's commitment to invest in infrastructure over the next several years, where they seek to make material progress in improving a housing deficit of 11 million homes. This has in fact produced a real boom for the P&Ls and balance sheets of Mexican construction companies.

TWST: Tell us about the research that you do. I realize your partners must do a lot of the research since they are on the ground, but do you do in-house modeling?

Mr. Gerken: Yes, we do. Our regional PM teams are actively engaged in developing their top-down macro views for their regions and generating bottom-up alpha. This is done by first-hand company visits, particularly with the small to mid-cap firms, continuously reviewing select bulge bracket and regional brokerage firm research, and capitalizing on the embedded infrastructure of our regional affiliates who are most often ranked in the top three in their regions in equities, derivatives, fixed income and foreign exchange. This infrastructure allows us to cover a broader geographic footprint of opportunities than most other funds. Moreover, our emerging markets structure and pool of Associate PMs give us a great platform for identifying some very exciting cross-BRIC investment opportunities.

TWST: Why do your very substantial regional affiliates elect to work with you rather than go it alone as they clearly have the in-house resources to do so?

Mr. Gerken: That is our most frequently asked question. Yes, they do have the resources and in fact many have tried to finance the start-up of their own 100% owned hedge funds. However, as is the case with most large asset management firms, exceptional performers ultimately leave to start their own small/mid-sized, independent funds, causing endless turnover for the large firms. Moreover, the new paradigm among large asset managers looking forward is open architecture in manager selection. Recognizing this, our partners share a common investment philosophy with us, appreciate our emerging markets track record that goes back to the mid-1970s and, most important, our shared view and commitment to risk management.

TWST: The last time we spoke, you expressed interest in India, Greater Russia and the Middle East.

Mr. Gerken: We continue to have that interest. We are hopeful to launch our Greater India and Greater Russia funds this year with designated regional affiliates and a Middle East fund early next year. In all cases, the management, structure and philosophy will remain the same, with only the on-the-ground regional affiliate and investment strategy changing to reflect local market conditions. Most important in each fund launch is the care and selection of our regional affiliate. Embedded requisite infrastructure (mid-office, risk management, trading platforms), a shared philosophy with GCA's efficient frontier approach to managing assets, prominent

ranking and skill sets across all the asset classes and the right inflection point are all essential selection criteria. Also important in ensuring economic alignment with our investor base, GCA seeds each fund with a \$25 million commitment, where half comes from GCA-related parties and the balance from the regional affiliate.

TWST: What about the risk in investing in these markets? Tell us about your risk management.

Mr. Gerken: We think this is critical as investors in the emerging markets are best served with best risk-adjusted returns rather than managers who hunt for best absolute return only. Performance must be accomplished with a protection of assets during corrections, and ideally being able to capitalize on the downturn to generate returns as well. In the case of our funds, we have been fortunate to be flat to up for the majority of the market downturns. Also important to our creed is the belief that managers are best able to generate above average returns in perpetuity if there is a visible commitment to building and maintaining an institutional grade management team with requisite infrastructure to scale AUM growth uninterrupted.

TWST: If you would look ahead to the rest of this year, are there any challenges or potential problem areas that investors in overseas market should be wary of?

Mr. Gerken: It always proves a challenge to filter the vast amount of business, political and journalistic press that gets thrown our way every day. Compounding this are periods like today where we try to assess the breadth, depth and timing of corrections in making sound investment decisions. This proves particularly difficult given that what moves markets to their extreme points is fear and greed — two very difficult and subjective factors to measure. The solution we trust is to identify the right funds and specialists to assist in this regard and to make sure they feel the same pain and gain as you do by aligning their economic interests with yours.

We think it entirely possible for 2008 to be a good performing year where we look to be 20% plus (net) for our funds, but it is more than ever important to discriminate your investment picks rather than to simply ride an index. It is also important to bear in mind that emerging market funds are intended as medium- to long-term investment vehicles, not short-term flips. This is oftentimes forgotten when investors receive daily, weekly and monthly NAVs prompting a near-term comparison and assessment.

TWST: Thank you. (PS)

Note: Opinions and recommendations are as of 4/7/08.

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