

Alternative Universe

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This Week's Features

Riding The Dragon

5

Even before China joined the World Trade Organization in 2001, its economy was already growing by leaps and bounds. Since then, the world's most populous nation has become an even greater economic player, and will likely soon surpass Germany as the world's third largest economy after the United States and Japan. Likewise, the number of hedge funds dedicated to investing in China has exploded from just a handful at the beginning of the decade to dozens today.

Blip, Bump or Slump?

14

The private equity bonanza has kept reporters like me busy over the past year. Day after day, month after month, this job involves dissecting larger more complex deals stretching into sectors private equity had never been before. Last week came news that the market had fallen. The Dow Jones Industrial Average fell 4.2%, its steepest drop since March 2003. Some blamed the crash on growing evidence that the problems in the sub-prime mortgage market are spreading and that this will make buyouts that had driven the market upward more difficult. Deteriorating credit conditions mean less liquidity for private equity firms to complete transactions.

Also in This Issue

- 4 Portus Moves Closer to Paying Investors
- 8 Amro Goes Neutral on Rival Bids
- 9 Flagg Street Victory
- 12 Schumer Opposes Raising PE Taxes
- 16 Summit Invests in Welltec
- 17 BSMB Buys Shipping Co

Hedge Funds Pages 3-11

Top News

- 3 Bear in Third Hedge Fund Crisis
- 3 Citadel Takes Sowood Portfolio

The Shadow Sows

- 4 The Complacency Wars-Chapter One

Dataview

- 5 Strategy Focus: Emerging Markets

Industry

- 8 SEC Bills HF Unit as Insider Trading Counter
- 8 Pardus Buying Up Visteon, Losing Bally
- 9 BISYS Shareholders Approve Merger
- 9 Blog: Subprime Bust Costs Mgr Yacht

People

- 9 SEC Fines Former Prudential Supervisor
- 10 IAM CEO Stepping Aside in Revamp
- 11 D.E. Shaw Hires Legal Ace John Liftin
- 11 Casari Joins Magnetar

Private Equity Pages 12-20

Top News

- 12 New Carlyle CFO, Deal With Goodyear's Union
- 12 Former Dell CEO Hired By TPG

Central Intelligence

- 13 You Don't Have to be No. 1

Dataview

- 15 Financial Sponsor Backed Acquisitions

Deals

- 16 Round Two For Senate PE Tax Hearings
- 17 CVC Asia Pacific Buys Nien Made
- 17 Behrman Invests in Healthcare Facility
- 17 BaseCamp Buys Builder

Funds

- 18 Goldman Start GS Direct
- 18 JMI Closes \$600M Fund
- 18 Third Fund Closed by Castanea

People

- 19 Quadrangle Nabs Yahoo! COO

Strategy Focus: Emerging Markets

Last 12 Months, Percent Returns, Emerging Markets Funds

The charts below present the aggregate performance of emerging markets hedge funds, according to HedgeFund.net-PerTrac Universes, a feature of PerTrac Online. HedgeFund.net-PerTrac Universes charts the aggregate performance of a total of 33 different hedge fund strategies.

	June 2007	May 2007	Apr 2007	Mar 2007	Feb 2007	Jan 2007	Dec 2006	Nov 2006	Oct 2006	Sept 2006	Aug 2006	July 2006
Funds In Universe	191	202	207	208	207	206	207	206	204	198	191	184
Mean	2.45%	1.98%	2.37%	1.80%	1.25%	1.05%	3.54%	3.60%	2.85%	0.29%	2.08%	0.93%
Standard Deviation	3.19%	3.80%	3.31%	3.08%	3.58%	3.05%	4.08%	3.61%	3.11%	2.77%	2.61%	2.09%
10th Percentile	6.10%	6.62%	5.59%	5.12%	5.14%	5.05%	7.20%	7.88%	5.61%	2.71%	5.13%	2.78%
25th Percentile	4.60%	4.35%	3.79%	2.82%	2.23%	2.05%	5.15%	5.85%	4.19%	1.03%	3.48%	1.96%
50th Percentile	1.88%	1.81%	2.16%	1.39%	1.05%	0.70%	2.94%	2.76%	2.71%	0.21%	1.45%	1.07%
75th Percentile	0.36%	0.28%	0.86%	0.61%	0.06%	-0.37%	1.52%	1.18%	1.19%	-0.70%	0.54%	0.07%
90th Percentile	-1.17%	-3.60%	-1.27%	-0.84%	-2.16%	-1.86%	0.21%	0.49%	0.19%	-2.65%	-0.22%	-1.20%
All Funds, Mean	0.84%	1.95%	1.73%	0.82%	0.61%	1.16%	1.63%	1.63%	1.67%	0.04%	0.87%	-0.19%

Emerging Markets Funds Performance, By Calendar Year

	2007 YTD	2006	2005	2004	2003	2002
Funds in Universe	179	159	135	101	79	69
Mean	12.15%	23.29%	26.73%	21.74%	41.84%	15.24%
Standard Deviation	12.14%	21.25%	32.01%	21.01%	28.82%	15.75%
10th Percentile	28.95%	57.30%	62.42%	46.77%	78.44%	37.26%
25th Percentile	17.03%	27.35%	33.86%	26.37%	54.45%	26.06%
50th Percentile	8.77%	16.81%	17.46%	15.39%	33.48%	13.18%
75th Percentile	5.17%	10.08%	7.46%	9.33%	20.20%	3.65%
90th Percentile	0.62%	5.21%	3.12%	3.77%	14.72%	-3.78%

Dataview Analysis

Riding The Dragon With China-Focused Hedge Funds

BY JAMES ARMSTRONG | Even before China joined the World Trade Organization in 2001, its economy was growing by leaps and bounds. Since then, the world's most populous nation has become an even greater economic player, and will likely soon surpass Germany as the world's third largest economy after the United States and Japan.

Likewise, the number of hedge funds dedicated to investing in China has exploded from just a handful at the beginning of the decade to dozens today. Many have managed to deliver double-digit returns even as hedge funds in general have struggled to stay above the S&P 500.

Karim Daou, one of the portfolio managers for the 788 China Fund run by Heritage Fund Management, is optimistic about China. He says it will likely continue to grow at an

impressive rate compared with other countries, including other emerging markets. Exports remain strong, and domestic consumption in China is increasing. PetroChina is currently the most profitable company in Asia, he says, and China now has the largest mobile phone carrier in the world, which unlike carriers in the U.S. and Europe, still has plenty more potential customers to tap.

The problem is, with astounding growth comes astounding volatility. In recent years, some Chinese indexes have experienced massive drops in a period of a few months. Daou says that does not change the long-term macroeconomic outlook for China. It does mean, however, investors in traditional investments like long-only mutual funds are subjected to tremendous short-term risk.

"If you believe that China is the

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HedgeFund.net-PerTrac Universes are available through PerTrac Online, an advanced tool for hedge fund analytics available exclusively to registered users of HedgeFund.net. The Universes provide a three-dimensional view of HedgeFund.net's hedge fund performance indices. Detailed percentile rankings are calculated each day for each of 33 investment strategies. The results are presented in easy-to-use tables and graphs. Alternative Universe provides monthly, yearly, and sector-focused views of PerTrac Online aggregate data on a rotating basis.

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place to be for the next 15 years, you will definitely have to consider some shakeups," Daou says. "You've had it already in the past."

That is why many investors in China are turning to hedge funds, which have the potential of evening out the bumpy ride, at least somewhat. Chinese capital markets are still developing, so it can be difficult for hedge funds to employ some of their traditional strategies. Shorting is not allowed in mainland China, though funds can short stocks listed on the Hong Kong exchange, and both Hong Kong and Singapore have China indexes that funds can use to synthetically short the market.

Lou Gerken, founder of Gerken Capital, which runs the GCA Greater China Fund, says capital markets in the region are developing

CONTINUED ON NEXT PAGE

Hedge Funds » Feature

CONTINUED FROM PREVIOUS PAGE

rapidly. Four or five years ago, he says, an equity derivatives market did not even exist in Taiwan. Today, Taiwan has the third largest equity derivatives market in the world.

Gerken believes similar changes are coming to mainland China. In the spring of 2006, China began its share reform initiative, which he says was the first time Chinese regulators got serious about looking at underlying fundamentals of Chinese capital markets.

“Whereas the Chinese economy has been a spectacular growth engine, the capital markets haven’t kept pace with the manufacturing base,” Gerken says.

That is changing. For now, however, a tremendous amount of money is flowing into China, and investors without actively managed accounts will likely feel the pain when sharp corrections hit what are still relatively immature markets.

Investing in China does not necessarily mean confining oneself to the mainland, though. Chris Ruffle, co-chairman of MC China Ltd., the manager of the Martin Currie China Hedge Fund, says he is currently over-weighting Taiwan.

“Taiwan has been one of the world’s worst performing markets this last decade, and I think that’s about to turn around,” Ruffle says.

The market in Taiwan has been very cheap for awhile now, and Ruffle thinks the upcoming elections will spark a recovery in confidence. In the past, elections in Taiwan have been an occasion for saber rattling between the island and the mainland. This time around, both of the main Taiwanese presidential candidates have been talking about more progressive links with China. Neither seems to want to be too provocative.

Government restrictions have meant Taiwanese money that goes offshore generally stays offshore, but as some of those provisions look as if they will be abolished, it should be easier in the future for money to flow back into Taiwan. That should buoy Taiwanese markets at a time when economic ties to the mainland are becoming increasingly important.

Since it has been exports to the West that have driven recent growth in China, it makes sense to be concerned about what might happen if the West were to turn on the rising dragon. Media reports abound of tainted food and toys with lead paint arriving from China, and politicians concerned with the chronically undervalued Chinese yuan have threatened punitive action.

“The safety issue is something that China is quite concerned about,” says Thomas Claflin, chairman of Tang Mei Funds, which runs the Wan Li Fund and the Tai Shan Fund. He says the government recognizes some companies have behaved poorly, and it is taking action.

Last month, the Chinese government executed the head of its State Food and Drug Administration on charges of bribery. Though that particular case did not involve safety issues, it nevertheless showed the government can be deadly serious about enforcement.

In addition, Claflin points out safety issues are not solely a Chinese problem. Many of the recently recalled products were sold by U.S. companies. He says something must be wrong with the inspectional services and quality

control of American companies if they allowed tainted products to ever reach the shelves.

Claflin thinks the threat of a backlash by the U.S. government is also unlikely. U.S. politicians might want to use China as a scapegoat, but if Congress goes too far, China could start selling the massive amount of U.S. debt it holds. Plus, if Congress did try to pass some sort of punitive tariff, it could end up backfiring.

“Much of the technology-based products are actually coming out of China, and they’re being built by subsidiaries of U.S. companies,” Claflin says. “If they attach tariffs on the wrong products, they’re going to end up penalizing U.S. companies as much as Chinese companies.”

A greater threat is the possibility of a world-wide slowdown.

Claflin says if there were a global recession, China would be adversely affected, but he says Chinese markets do not pose any specific risks greater than those of other emerging markets.

Emerging market hedge funds were up 12.15% for the first half of 2007, according to the HFN Averages. In fact, hedge

funds investing in emerging markets have had double digit returns every year since China joined the WTO. Perhaps that is just a coincidence, but few emerging market managers will deny the importance of China over the last decade.

Investors are clamoring to get into China, though many are still put off by enormous booms followed by steep corrections. China-focused hedge funds provide one entryway to an important yet volatile market, and more and more investors seem to be knocking.

“Whereas the Chinese economy has been a spectacular growth engine, the capital markets haven’t kept pace with the manufacturing base,” Gerken says.