HEDGEWORLD EXCLUSIVE

GCA and the Running of the Greater China Bull

Lou Gerken talks about successes and setbacks with the (sometimes slow) progress of emerging capital markets, with the spotlight on the Greater China region.

By Maggie Shea

Lou Gerken, Gerken Capital Associates
"We spend a lot of time searching for the right local joint-venture partner for long-term agreements."

Predicting a 20- or 30-year bull market for the Greater China markets alone, Lou Gerken, founder and chief executive of emerging markets alternative asset adviser and fund manager Gerken Capital Associates, says the biggest challenge managing emerging market hedge funds is not getting investors to allocate to the booming emerging markets, but rather finding institutional-grade managers with a presence on the ground there. With the recent rollout of its Greater China hedge fund, Gerken Capital is moving further into the fund manager role, and Mr. Gerken finds that aside from having partners and research capabilities in local markets, he must invest a great deal of time to be there himself.

San Francisco-based Gerken Capital has been investing in emerging markets since its inception in 1989, and most of its principals have been involved in those markets even longer. By and large emerging market funds still take an equity long-bias because of the long-term growth of the sector and the fact that—despite the rapid transformation of those markets—the underlying financial tools of the markets aren't as developed as the United States, Mr. Gerken says. Just as an example, he says "50 of the 55 Greater China hedge funds are equity long/short." So Gerken Capital's first step was to establish "the right partners with a broad base of experience across asset classes," on the ground in these markets, he adds.

>> CONTINUED ON PAGE 40

SOCIALLY RESPONSIBLE INVESTING

<< CONTINUED FROM PAGE 39

social criteria. But he does not limit his short stock-picking to such stocks. As an example, he notes that in the food sector, his fund may be long companies that produce healthy foods while being short the stocks of companies that sell processed food or food saturated with fat with little nutritious value.

"We could even short the stock of a socially responsible company," he says. "If the stock is ridiculously overpriced, we would short it. I don't think I have to shy away from the idea of shorting any company if I think the price is out of synch with reality."

Mr. Keefe mentions that for some investors, shorting may be troublesome to the extent that a manager who is short the stock of a company may take a position on the proxy vote that could be detrimental to the interests of long-term investors. "But there's nothing inherently problematic in shorting the stock," he says. Some socially responsible hedge funds have chosen to be to be long companies that passed socially responsible tests while shorting all other sorts of stocks, he said. "I'm not advocating it, but it's a possible socially responsible investing strategy for hedge funds," he says.

For some, the shorting issue explains why hedge funds have yet to jump on the socially responsible investing bandwagon. "The hedge fund skill set is how to short, how to manage risk. The skill required in socially responsible investing is mostly in large-cap stocks. Very few people have skills in both areas," says Mr. DeSantis.

As a former chairman of the investment committee of Independence Investment, a subsidiary of John Hancock Financial Services, Mr. DeSantis says that he used to manage a lot of money for religious groups, endowments, not-for-profit groups and public pensions, all of which had an inclination toward social investing. In addition, he managed a long/short strategy applying a quantitative discipline. "I saw the need for growth in socially responsible investing," he says.

According to Mr. DeSantis, hedge funds avoid being involved in socially responsible investments mainly because this style of money management has historically focused on big-cap stocks. "If you want to gain social visibility for social impact, you're better off focusing on an Exon than on a small company."

But things are progressively changing. With the mainstream interest in global warming and environmental issues increasing, it may now be time for alternative investment managers to pay attention to social and moral causes as the stocks of socially involved companies may benefit from a renewed popularity.

"I think socially responsible investing can be done by hedge funds and it will be done. You'll see more socially responsible hedge funds or sustainable hedge funds. You're going to see some launches," says Mr. Keefe. His firm, he adds, is not ruling out launching a hedge fund for the first time in this sector along with the socially responsible mutual funds it is already operating.

Many hedge funds already follow the Taoist advice and serve the common good via philanthropy. It's only a matter of time before their investment style becomes more socially focused as well. ai

GREATER CHINA BULL

<< CONTINUED FROM PAGE 17

Thus Gerken Capital makes it a priority to find joint venture partners in each of the regions it covers. "The markets are all different, and unless you have people on the ground you can't capitalize on the cross-market, cross-sector trading," Mr. Gerken says. "We spend a lot of time searching for the right local joint-venture partner for long-term agreements." These include partnerships with a Taiwanese investment management company, a Spanish bank with established branches across Latin America and India's oldest investment house.

From the firm's inception through 2004, Gerken Capital has incubated around 20 funds representing $4.5 billion under management, Mr. Gerken says. Gerken Capital currently manages or advises five private equity and hedge funds with around $1.5 billion in assets under management—this figure includes around $100 million for the firm's five managed BRIC funds, being rolled out over a roughly three-year period in response to growing confidence in emerging markets' infrastructure, currency stability and risk management and thus, the potential for more consistent returns.

"In 2005, we decided to morph our legacy business into the rollout of five BRIC funds we'd be manager to," Mr. Gerken says. The British Virgin Islands master feeder, GCA Funds Ltd., was created in 2005 to offer segregated share classes in India, China, Latin America, Russia and the Gulf Cooperation Council.

Gerken Capital uses a cross-BRIC trading platform, which

>> CONTINUED ON PAGE 41

<< CONTINUED FROM PAGE 40

means shares are rotated on a monthly basis, allowing G7 (excluding Russia) investors to divide their allocation among a combination of BRIC markets or focus on just one piece, making a 20% or 30% allocation to the emerging markets fairly easy, Mr. Gerken says.

The platform offers tremendous additional alpha for Gerken Capital as a manager, he adds. "There is little spoken to trading and investment activity between India and China, China and Latin America, etc. This gives us a resource to generate traction in those areas." Cross-BRIC trading also is attractive because of the low correlation among each of the players. "The correlation between the emerging market players is much lower than most people think," Mr. Gerken says, adding that if contagion were to hit one of the markets, it wouldn't necessarily strike all of them, contrary to what most people believe.

Gerken Capital's core team consists of nine investment professionals, each with more than 20 years' experience. There are 12 senior advisers to Gerken Capital, and the firm has correspondent offices in Hong Kong and London.

Focus on China

One of the first Gerken Capital-managed funds is GCA Greater China fund, which was launched in December 2005 and returned 4.43% month-to-date as of July 6. "On a risk-adjusted basis we're quite pleased with the half-year results," Mr. Gerken says. "We're up 22% net for the year…. We were up 26% net last year [2006] with 7% volatility. Both were generated without leverage." Gerken Capital has the ability to use up to 2.5 times leverage, but "we haven't used it," Mr. Gerken says. "We want to manage our net exposure carefully and preserve the principal."

The fund is an absolute return hedge fund that focuses on investments in Hong Kong, Taiwan and Mainland China. Taiwan-based Polaris Investment Management Ltd., which focuses on Greater China's small- to middle-sized enterprise sector—as the midcap space accounts for roughly half of emerging markets' GDP, Mr. Gerken says—co-manages the fund with GCA. The fund charges a 1.5% management fee and 15% performance fee and uses the MSCI Golden Dragon equity markets index, which is an aggregate of MSCI's Hong Kong, China and Taiwan indexes.

Asked about the success of the Greater China fund, which returned almost 9% month-to-date on June 22, Mr. Gerken says "there are select sectors we've been overweighting; we caught the market right and had some good returns. The market itself continues to advance upward, benefiting from market momentum." But, he adds, "We don't like to *promise* those kinds of returns."

Emerging Capital Markets Play Catch-up

In conjunction with Polaris, Gerken Capital's team does a lot of research on the Greater China region, which is growing at a rapid rate.

China first opened its doors to investors in the late 1980s; prior to that, available emerging markets included Japan, Hong Kong and a select few Latin American markets. And although the opening of China triggered rapid economic growth there, the development of the capital markets hasn't been quite so fast, Mr. Gerken notes.

"The Chinese government and regulators finally prioritized in the last year to keep up with the rapid economic growth," he says, citing the share reform initiative launched there last April, which called for all reformed listed companies to offer additional shares or funds to private investors to compensate for potential losses their portfolios' value when the publicly owned shares hit the market. The reform was seen by regulators and investors as crucial for China's capital markets to function fairly and openly for both majority and minority public shareholders.

Mr. Gerken also notes recent statements about introducing new financial products in the Chinese market to boost liquidity, transparency and financial security. For example, he says, last August the Chicago Mercantile Exchange began listing yuan-dollar, yuan-yen and yuan-euro futures and options. In early September, the Singapore exchange started trading stock index futures targeting China's A-share market. Shortly following, Shanghai launched its fourth futures exchange, Financial Futures Exchange, trading stock index futures for institutional investors. Furthermore, funds are now able to hedge indexes and exchange-traded funds in China, Hong Kong and Taiwan. And, while funds can hedge on futures, options and individual securities in Hong Kong and Taiwan, this is not yet the case in China, though it is expected that funds will be able to hedge on futures some

>> CONTINUED ON PAGE 42

<< CONTINUED FROM PAGE 41

time in 2007.

Nonetheless, these innovations and reforms to the Asian markets spurred the introduction of equity warrants—the first equity derivative—to China's stock market, with the 2005 state-share reform of China's largest steelmaker, the Baoshan Iron & Steel Co. Ltd. They also opened the door to new mergers and acquisitions activity in state-owned companies—namely the Carlyle Group's controlling stake in Xugong Group Construction Machinery Co. Ltd., which the private equity fund took late in 2005.

But China's capital markets still have a ways to go, and Mr. Gerken—using the more-developed Latin American capital markets as an example—demonstrates why. We can examine how investor-friendly emerging markets are in terms of how they've progressed regarding foreign investor ceilings and trading costs, to name a few, he muses. "Investors in China can invest via Hong Kong," Mr. Gerken says. "And [Class-]A shares are available to [qualified foreign institutional investors] only. Whereas in Brazil and Mexico, investors can invest across all share classes." Additionally, China charges a 10% withholding tax on interest and a 33% tax on capital gains; in Brazil there is a 15% interest tax, and 0% on capital gains, Mr. Gerken notes.

"The investor-friendliness of China is changing, but it is still not up to speed with Latin America or the U.S.," Mr. Gerken says. "If you look at the economic and market metrics, China has the world's fifth- or sixth-largest economy. Latin American economies are 12th, 15th 30th and 40th—not as large from a GDP standpoint." He adds that China's nearly 10% growth rate is double that of the United States and also outshines the 6% to 7% growth rate in Latin America.

The Man Behind the Manager

So where did Mr. Gerken's attraction to the emerging markets come from? "I've been dealing in emerging markets since I left graduate school," Mr. Gerken says. The place Mr. Gerken says was the genesis for his interest in the emerging market space was British money manager GT Capital, where he worked an analyst and portfolio manager prior to founding Gerken Capital. GT Capital was one of the first funds to invest in emerging markets, he says. Mr. Gerken also has worked as a managing director and head of Prudential Securities Technology Investment Banking. He was president of telecommunications consultant TCG International and has worked with Wells Fargo Capital Markets and Montgomery Securities.

Now the essential "global CIO" of Gerken Capital, Mr. Gerken says he spends a lot of his time talking to local markets. "We've come a long way in these emerging markets, and we're establishing our footprint," he notes. Visiting Singapore and New York in May; Stockholm, Sweden and London in June; and Hong Kong in September for the Hedge Funds World India conference, Mr. Gerken spends about half his time working on the road. But no matter how many weeks each year Mr. Gerken spends visiting with emerging market representatives "it still amazes me the huge cultural and structural differences between the markets," he says. Further, the rate at which the underlying markets in places like Hong Kong and China are changing makes it difficult to keep up with the constant inflow of new information. "It compounds that difficulty when you're dealing in five emerging markets," Mr. Gerken says.

Along with the GCA Greater China Hedge Fund, Gerken Capital, in a joint venture with Spanish Bank BBVA Group, will launch the GCA LatAm Fund on Aug. 1. The firm plans to launch the GCA India Hedge Fund in September, as well as Russia and GCC vehicles in late 2007 or early 2008, Mr. Gerken said. In addition, Gerken Capital is exploring a possible listing on the London Stock Exchange's Alternative Investment Market.

When he's not busy with work, Mr. Gerken is a self-proclaimed "boring" guy, spending most of his time with his two-and-a-half-year-old daughter, Alexandra. So would he like to take her with him on his global treks? "I want to take her, but it wouldn't be too much fun for her now—I have lots of meetings," he says. But hopefully next year, when things start to settle down, Alexandra can be on the ground with Mr. Gerken. "As we get the platform rolled out, I'll have more time to extend my stays."

But for now, Gerken Capital is on the fast track to reach its goals, he says. "People think when Google goes public at $30 billion market cap, that's pretty easy. Well, every day Google died 1,000 deaths. It takes constant monitoring and management. If you get caught asleep at the switch, it's not a good scenario." ai