PROFESSIONAL
INVESTOR
THE OFFICIAL JOURNAL OF THE UK SOCIETY OF INVESTMENT PROFESSIONALS
JUNE 2004

HOW LIQUID IS THE PROPERTY MARKET?

TWO VIEWS OF CP176

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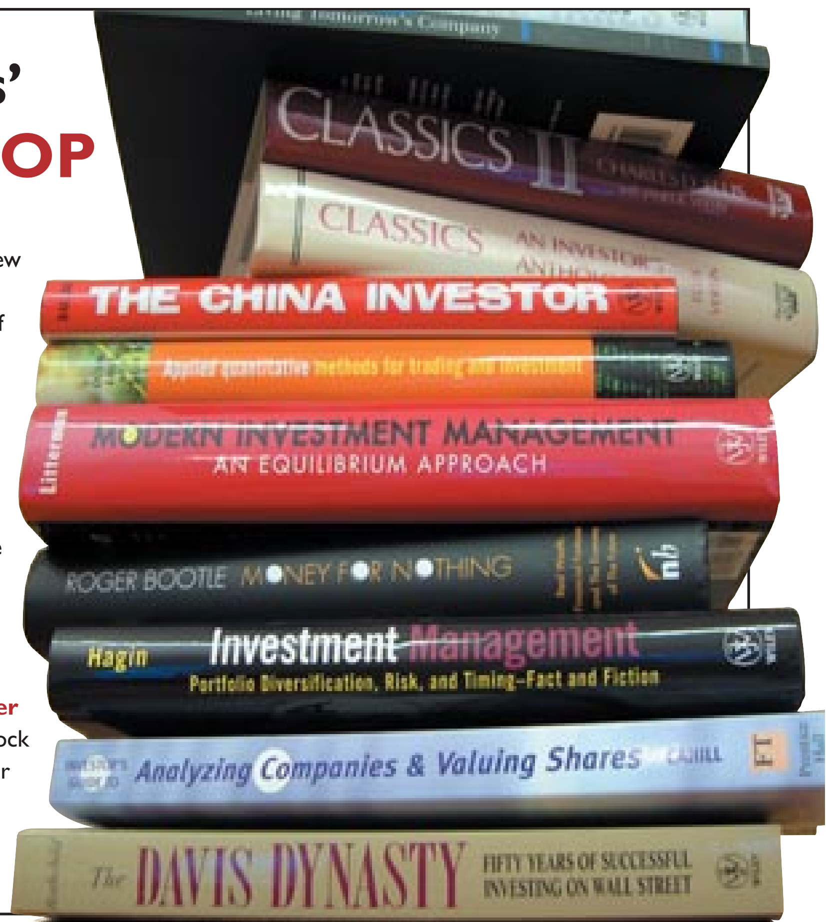
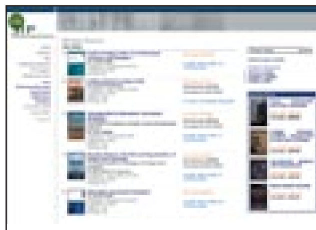


Every issue of *Professional Investor* takes care to review a new book of potential interest to UKSIP members. Inevitably, however, numerous new titles cannot be reviewed, many of which will be of real interest to investment professionals.



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To see the range, visit the UKSIP website, click on **member resources** then on **bookshop**. Most books are held in stock and can be despatched on the day of order. If your company wants to set up a corporate account, please e-mail **Philip Jenks** on **uksip@global-investor.com**

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The objects of the UK Society of Investment Professionals are to achieve, foster and maintain (by examination or otherwise) high standards of professional ability and practice in investment analysis, portfolio management and related disciplines; to encourage the creation and interchange of ideas among those engaged in these activities; to advance public understanding of their functions and techniques and the operation of security and other investment markets; and to support and promote the interests of the investment community. Details of the Society's work and activities, and applications for membership, are available from its offices at 21 Ironmonger Lane, London EC2V 8EY.

PROFESSIONAL
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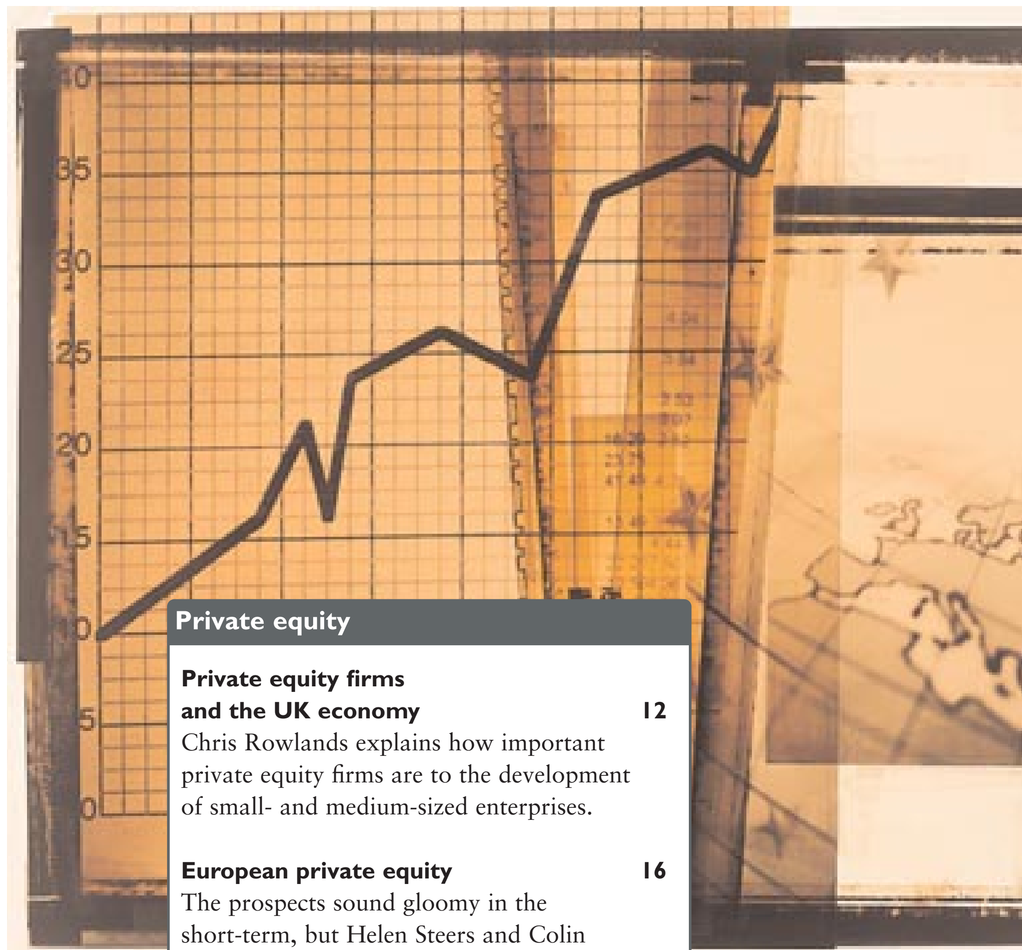
JUNE 2004



Private equity

Private equity firms and the UK economy 12
Chris Rowlands explains how important private equity firms are to the development of small- and medium-sized enterprises.

European private equity 16
The prospects sound gloomy in the short-term, but Helen Steers and Colin Wimsett think that the future really is brighter long term.

Market developments in the UK 20
Simon Wildig discusses the key trends in private equity in the UK, particularly the prospect that firms sell more companies than they buy.

Bundled research services 23
Jamie Stewart and Richard Szwagrzak offer some thoughts on the fallout from the FSA's consultation paper on bundling, softing and transparency.

Commercial property 27
According to Colin Lizieri, the risks associated with this asset class can be significantly reduced if investors diversify by building a larger portfolio.

Regulars

Society News	2
Leader	5
AIMR	6
Book Review	7
AIMR Europe	10
David Smith	11
Viewpoint	31
Lifestyle	32

Investment Management Certificate - a milestone is reached

Ten years have passed since the former Institute of Investment Management and Research launched its Investment Management Certificate (IMC) examination. Since its launch in 1994, over 14,000 candidates have passed the exam and thereby demonstrated their regulatory competence in relation to the management of investments. During that time, the IMC has become recognised by the fund management industry as the entry-level qualification of choice for those working in financial analysis and investment management in the UK. Recently, a larger number of pensions professionals have taken the IMC to demonstrate their investment expertise in the wake of the Myners Review. The IMC is often quoted as a pre-requisite for posts in investment management companies and to celebrate its success UKSIP is planning a major social and networking event in late September. The July/August issue of *Professional Investor* will contain full details of this together with information about a new "IMC" class of membership designed to provide support to investment professionals who are successful IMC candidates.

Member services

In the May issue UKSIP also announced that a 'members only' section of its website was being developed, primarily to provide a 'jobline' service, whereby employers looking for staff will be able to post vacancies directly for the attention of members. Currently this site is being tested and members are encouraged to let the office know of any particular facilities they would value on this 'members only' section. Please send any views to **john@uksip.org**

It is some years since the society surveyed its members to understand better how they perceive the services and support offered by UKSIP. During the next few weeks all members will be contacted and invited to complete a short questionnaire on member services so that we use this feedback to improve further the services available to members.

UKSIP needs you – and your email

As the Society is making greater use of emails to keep its members informed about key developments, please ensure that you are not missing the latest news by providing your email address in one of the following ways:

- by emailing **uksipstaff@uksip.org**
- by visiting **www.uksip.org** and completing the "contacting UKSIP" form
- by calling **020 7796 3000** with your email address. Failing that, we will even take your email address by post!

UKSIP in Scotland

Colin McLean, FSIP

In conjunction with Colin McLean who chairs its Scottish branch, UKSIP is planning to bring a number of its more successful professional development events to Edinburgh or Glasgow so that its Scottish members can be briefed and can network more easily. The first of these events is a full-day seminar on Thursday July 1st 2004 by Professor Chris Nobes who will provide an update on International Financial Reporting Standards. This event has just been run in London, where it was very well supported by analysts, brokers, fund managers and others who need to interpret financial statements prepared under International Financial Reporting Standards and who wish to bring their knowledge and understanding of these standards up-to-date. A number of Scottish-based members have asked for some of our more successful events to be exported northwards and UKSIP does hope that members and their firms will be able to support this seminar. A brochure about the day is available at **www.uksip.org** under Continuing Education.

AIMR subscriptions – income tax relief

Members of UKSIP and AIMR will be pleased to note that the Inland Revenue has recently confirmed that AIMR has been approved under Section 344 of the Income Tax (Earnings and Pensions) Act 2003 so that AIMR - as well as UKSIP - member subscriptions now qualify for income tax relief. As AIMR has only recently been approved, members may find it helpful to quote the following reference number in dealings with the Inland Revenue: **SAPP/T1644/30/2003/JEM**.

Delays to forthcoming office relocation

UKSIP was able to announce in the last issue of *Professional Investor* that its office will relocate to **90 Basinghall Street**, which is very close to Guildhall. The Society is still dealing with a number of legal formalities and so full details of the move to new premises are now likely to be available in the July/August issue.

India – the new Asian economic giant

John D. Evans CFA, Lecturer, Regent's Business School and a member of UKSIP's Professional Development Committee reports on a recent UKSIP Evening Discussion.

On Thursday, April 22nd, at the offices of UBS Global Asset Management, UKSIP held a discussion evening on the topic of India and its recent economic progress. With a population of over one billion people and an annual GDP of $600 billion, equal to Korea and larger than Spain, India is becoming of great interest to investors, both portfolio and direct.

Working with UKSIP in organising this topical event, I was fortunate that one of the top economic and political risk consultancies, Prognoses, (**www.prognoses.com**) agreed to make the presentation. Prognoses was set up in 2003 by its chairman, Michael Young, OBE, who has a long history in political risk analysis and consultancy. He was the individual who established and chaired secret discussions between the African National Congress and the then South African government, leading to public process that brought the ANC into the political and governmental system. His more recent idea was to fuse political and economic analysis to provide clients with a broader perspective, something that is often missing in today's highly specialised markets. Other principals in Prognoses are Charles Dumas, head of international economics at Lombard Street Research, Jonathan Fenby, CBE, former editor of the *South China Morning Post*, *The Observer* and Reuters World Service and Sir Colin McColl, chief of MI6 from 1988 to 1994. Both Charles and Jonathan spoke with Michael at the seminar. As is normal for UKSIP discussions, the session started with drinks and light snacks at 17:30 and the presentation at 18:00 sharp.

About 40 members of the society were present, which is a typical size for an 'after-work' event of this nature and allows for direct questions and one-on-one discussions with the principals after the formal presentation is over, which was about 19:30. After the presentation, UBS provided us with an extremely pleasant reception room with drinks and warm and cold snacks for a period of about one hour. For a member of the UKSIP, it would have cost £25.00 to attend.

Attending the discussion evening from Regent's Business School were Imran Gul and Stuti Kamani, students in the Masters of International Management degree and taking a course in International Accounting and Finance. Two of the topics covered in the course are country risk analysis and foreign direct investment. Clearly, the presentation on India provided a very real and very professional analysis of these key topic areas. However, there was more to the presentation than academic knowledge. For a student who has not worked in the industry, simply participating in an event at the offices of a financial institution, which are quite different from an academic institution, and being able to mingle and speak with people of all ages and experiences, provides a real 'taste' of being active in the business.

For business students looking for a career in the financial markets, professional associations such as UKSIP (**www.uksip.org**) provide an opportunity to attend seminars and presentations that directly input their studies, as well as an opportunity to meet and interact with market professionals in a relaxed environment. Too often, students only consider the 'direct route' to a potential employer and do not consider all of the other ways and means of getting involved in the industry and establishing those ever-so-important personal relationships. Members should note that the India event is one in a current series. China was covered some weeks back and a session on Russia is scheduled for Thursday June 29th. Both Canada and Europe's new accession countries are in the pipeline.

John Evans introducing the principals of Prognoses (seated), Michael Young (centre), Charles Dumas (right) and Jonathan Fenby (left).

RBS Masters students Imran Gul (second from left) and Stuti Kamani (centre) at the reception after the presentation.

UKSIP CFA® Revision Clinics - Spring 2004

As part of our programme to support candidates preparing for the June 2004 CFA® examination, UKSIP recently held four Revision Clinics for each of the three levels at the London School of Economics. The clinics were very well received and we would like to thank the following members who acted as volunteer instructors or who helped to produce the clinic material:

James Andrew CFA
David Aserkoff CFA
Andrea Bertolotti CFA
John Bocchino CFA
Pablo Carbajal CFA
James Chu CFA
David Costin CFA
Jeremy Cranford CFA
Luke Dixon CFA
Gerard Donohue CFA
Frank Fehle CFA
Michael Fischer CFA
Claire Halliday CFA
Christina Haemmerli Schlegel CFA
Avi Hooper CFA
Ozgur Kaya CFA
Tassos Kotzanastassis CFA
Jason Lejonvarn CFA
Alan Linsley CFA
Daren Miller CFA
Tim Nuding CFA
Mark Olson CFA
Kaisa Paavilainen CFA
Fred Rizzo CFA
Michael Sonenshine CFA
Maggie Stoker FSIP
Sarpel Ustunel CFA
Andrew Winn CFA

UKSIP Golf Day - 25 June 2004

Bookings are now being taken for UKSIP's Golf Day at the Royal Ashdown Forest Golf Club, Forest Row, East Sussex. If you would like to join the contest for UKSIP's golf salver, visit **www.uksip.org/memberservices/socialevents** to register.

Golfers among you know that the Royal Ashdown Forest Club is a wonderful venue and that the charge of £90 is modest for a full day's golf, including morning coffee, lunch and afternoon tea.

Associate members elected since April 1st 2004

Name	Company
Paras Anand	Deutsche Asset Management
Robert James Inkey White	Gerrard

New candidate members accepted since May 1st 2004

Santosh Raj Pandey	-

Professional Development and Events programme - June to September 2004

Date	Event	Venue
Thursday June 3rd Discussion evening	**Distressed Debt** - The inside track	City Marketing Suite London, EC2
Wednesday June 9th Afternoon seminar	**Behavioural Finance**	Painters' Hall London EC2
Tuesday June 22nd Discussion evening	**Investment in the 21st Century** Meeting expectations	Chartered Insurance Institute London, EC2
New **Tuesday 22 June** Full-day seminar	**Asset Allocation Workshop** Contact Ibbotson www.ibbotson.com	Cafe Royal, Le Meridien, Piccadilly, London, W1
Thursday June 29th Discussion evening	**Russia - from bust to boom**	UBS, 21 Lombard St London, EC3
Friday June 25th	**UKSIP Golf Tournament**	Royal Ashdown Forest Club
Thursday July 1st Full-day seminar	**International financial reporting** - What's new?	Hilton Edinburgh Grosvenor Edinburgh
Tuesday July 13th Discussion evening	**Why Europe matters to the investment professional**	IMA London, WC2
New **Wednesday July 14th** Full-day seminar	**Indices, benchmark setting and performance measurement**	London Chamber of Commerce London EC2
New **Tuesday Sept 14th** Afternoon seminar	**A behavioural approach to asset allocation**	Weaver Suite, 90 Basinghall St London EC2
New **Wed Sept 15th** Inaugural lecture	**Eminent speaker: Jeremy Goford**	TBC

All UKSIP seminars and discussions are open to both members and non-members.

This programme is correct at the time of going to press. Further events may be added from time to time. Full details of all events, including registration forms, will be available on the UKSIP website, **www.uksip.org** Please also check the website regularly for details of any additional events.

UKSIP seminars and discussions are qualifying events in the AIMR Professional Development programme.

For full information on the forthcoming Discussion Evenings please see the centre pages.

Who's who in the office?

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Tracy Blake	*PA to the Chief Executive* tblake@uksip.org
Stephen Fryer	*Director of Education & IT* stephen@uksip.org
Roje Khalique	*Asst Director of Education & IT* roje@uksip.org
Sean Lo	*Director of Finance* sean@uksip.org
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Website - **www.uksip.org**

What's in a name?

Following an extensive canvassing of members - and an overwhelming vote at its Annual Meeting - AIMR has been rebadged as the CFA Institute. CFAI's mission - to lead the investment profession globally by setting the highest standards of education, integrity and professional excellence - means that UKSIP members here in the UK have a crucial role to play if CFAI's ambitious programme to be recognised as a regional force in Europe is to be achieved in the medium term.

During the coming months, UKSIP will be pressing CFAI officials to fully understand the sensitivities associated with operating in the UK and the need, in particular, to promote the significance behind CFAI/UKSIP membership in the context of high professional and ethical standards.

Also, UKSIP's wholehearted support for the CFA Charter as the way forward globally, does not mean that the CFAI should not fully recognise the value of the ASIP designation that so many UKSIP members have achieved. CFAI is currently on notice to support its large UK membership as strongly as possible.

Reality or illusion?

In over 30 years in the pensions business, there have been very few occasions I have experienced where pensions issues have made the front pages of the tabloids or headlined on *News at Ten*. However, over the last few years much coverage has been given to the seemingly large deficits that exist in pension funds, and not just in the UK.

The reported FRS17 numbers in particular, have caused much consternation to members, management, shareholders and analysts alike. In some cases the reported numbers have led rating agencies to downgrade the credit ratings of companies.

But do we really understand the numbers that are being highlighted? Are they a true reflection of reality? Is it really understood that these are just one measure (albeit an important one) of the present value of promises that will be paid out in as much as 40 years time for payment periods of maybe 30 years?

The length of these projection periods make the results very susceptible to the assumptions used. Most analysts and company managements have grasped the link with the discount rate used (the double-A corporate bond yield), but most have missed the importance of the inflation assumption used in calculating the future level of benefits.

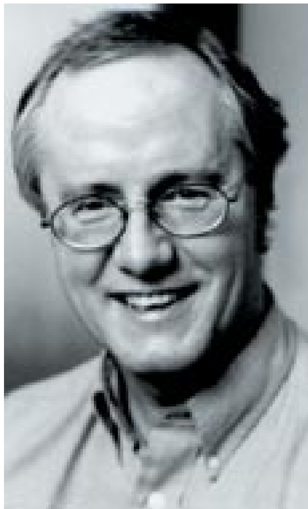
Given the time horizons involved, the judgement of future inflation is a vital assumption. The FRS17 accounting standard suggests that company directors (with advice from their actuary) should take the difference between the yield on index-linked and conventional gilts as the market view of future inflation. This is the method most follow. Over the last year, that yield gap has risen from 2.7% to 3.0%. The impact on benefit liabilities is significant, giving a rise of over 15% in those liabilities!

Only time will tell whether it is right. The key problem for investors (and pension scheme members) is that this basis relies on the yield gap being a good predictor of future inflation. With the dearth of new index-linked issues and the demand pressures that exist, its prediction capabilities must be suspect. In terms of developing investment strategies to exceed these forecasts, it becomes even more difficult, if not impossible, given the corporate bond discount rate also assumed.

I do not minimise the problems pension funds face or the deficits that there are likely to be, but I do wonder how accurate some of the headline numbers will turn out to be. If we are clearly wrong then we stand to do great damage to our reputations and the trust others place in us.

John Finch ASIP
- Investment consultancy director at HSBC Actuaries and Consultants Ltd for the past seven years.
- 27 years working for the pension fund management arms of two life insurance companies.
- Completed his Society of Investment Analysts exams in 1990
- Affiliate of the Institute of Actuaries and Fellow of the Chartered Insurance Institute
- Board member of UKSIP.
- email: john.finch@hsbc.com

The independence debate



John Barrass explains joint efforts to develop a code of practice that will help ensure the objectivity of research analysts

Debate surrounding ISD 2, as the Financial Markets Instruments Directive is now officially known, has been lengthy and at times heated. Much of it has focused on "internalisation," whereby banks execute one client's buy order against another client's sell order, as well as execution-only trades, which require no investment advice, full pre-trade transparency for pricing and volumes and "normal market sizes" for exchange based trades.

Majority agreement on most aspects of the directive was finally reached in March; although the internalisation debate is set to rage on, as regulators grapple with the issue of the threshold of order size below which banks will have to publish firm bid and offer quotes.

Meanwhile, another debate has been rumbling in the background - the debate about analysts' independence.

Decisions about how investment banks deal with the conflicts of interests faced by their sell-side analysts have been left to secondary legislation to be drawn up by Europe's securities regulators. It seems unlikely that something akin to the historic US "Spitzer Settlement," responding to allegations of biased stock ratings in order to lure investment banking business, will be adopted in Europe. But if it is, a mere separation of research and investment banking activities will no longer be enough to guarantee research independence and objectivity.

Under the settlement, 10 of the biggest Wall Street firms paid over $1.4 billion to fund and promote better independent research and educate investors. Former star analysts were fined up to $15m and banned for life from working in the investment industry. And the SEC has defined independent research as "having no association with investment banking activities".

Guidelines

The CFA Institute, (the re-branded AIMR), joined forces with the National Investor Relations Institute (NIRI) in the US to develop ethical guidelines governing the relationship between securities analysts and the corporate issuers they follow. These guidelines aim to establish a benchmark of best practice by stipulating that analysts must remain objective, conduct thorough and diligent research, and never bias their research reports in an effort simply to make companies happy or to receive better information or access. They also require that corporate issuers should not discriminate solely on the basis of whether an analyst has written negative research or recommendations. Nor should they deny information or access in an attempt to influence research, or exert pressure on analysts through other businesses relationships.

Disparities between European member states' legal and regulatory structures and market characteristics mean that a European agreement on ensuring analyst independence would have to be tailored to accommodate local differences under principles or guidelines applicable on a pan-European basis. These would have to address the needs to identify, eliminate, avoid, manage and disclose the conflicts of interest to which analysts are subject, as was made clear in the European Commission's report on Research Objectivity issued on September 4th, 2003.

The CFA Institute's own best practice guidelines set out in the Research Objectivity Standards for Equity Research published in May 2003, together with the recently concluded work with NIRI, could be useful in helping to establish industry-developed ground rules providing comfort for sell-side analysts and corporate issuers alike. Even if precedents set across the Atlantic are not followed in their entirety, whatever solution is ultimately adopted will probably impose a degree of regulatory cost and have some impact on firms' structures within the European capital markets as a whole. One thing looks certain: a "one-size fits all" approach at a detailed level would be nigh on impossible to implement, so the debate about where and how to draw the line between pan-European principle and national prescription is set to continue. ■

Corporate issuers should not exert pressure on analysts

John Barrass is AIMR vice president, global affairs, Europe. Email: john.barras@aimr.org

UKSIP Support Programme for Chartered Financial Analyst® Candidates

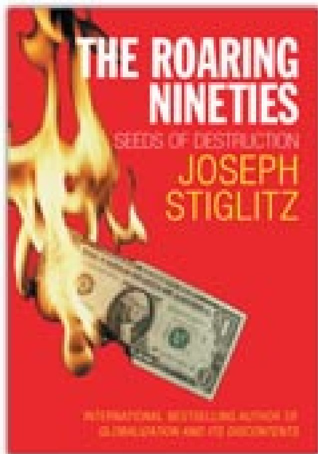
Each year we organise a programme of activities to assist candidates preparing for the CFA examinations. We recognise that candidates' requirements will vary markedly, depending on their prior knowledge and area of employment. Activities in our programme are designed, therefore, as individual units which candidates can use as they construct their own study programme, building on their existing knowledge and complementing courses provided by their employer or other training providers.

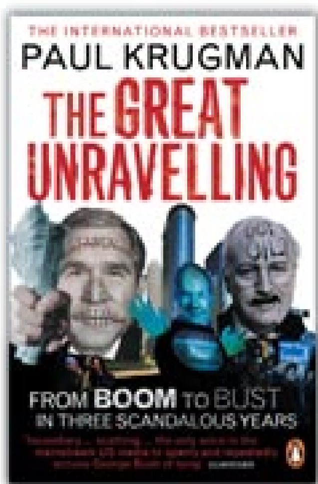
The activities include:

- Formal Courses of varying lengths
- Practice Exams
- Scholarships
- Revision Clinics
- Study Groups

Most of the activities are open to both members and non-members of the Society. Candidates may become members of UKSIP once they are registered with AIMR for the CFA program. If they do, they will receive a range of membership services including Professional Investor and be eligible for significant discounts on most of the Society's activities including the CFA Support Programme. They will also have free access to the Institute of Financial Services library at 99 Bishopsgate, London, which holds reference copies of all the CFA recommended readings.

For further information visit the CFA Support section of the UKSIP website - **www.uksip.org** or telephone the UKSIP office - **020 7796 3000**.





How has it all gone so wrong?

The Roaring Nineties - Seeds of Destruction
By Joseph Stiglitz, Allen Lane, 2003, pp 432. £18.99. ISBN 0-713-99722-2

The Great Unravelling - from boom to bust in three scandalous years
By Paul Krugman. Allen Lane, 2003, pp464, £18.99. ISBN 0-713 -99743-5

Reviewed by Russell Sparkes

Four short years ago, the American economic model reigned supreme. Unemployment was at a post-war low, yet there was no sign of inflationary problems and soaring productivity fuelled US corporate profits, and the Dow. Now, the stock market is emerging from its worst setback since the 1930s, capital spending is depressed and unemployment seems impervious to economic recovery. Worse still, the US is running high trade and budget deficits that are likely to cramp future growth. How has it all gone so wrong? If Greenspan took all the credit in the 1990s, shouldn't he shoulder some of the blame now?

I looked forward to answers to these questions in *The Roaring Nineties* by Joseph Stiglitz, and *The Great Unravelling* by Paul Krugman. Both writers are leaders in their field. Stiglitz is a Nobel Prize winner and professor of economics at Columbia; Krugman teaches at Princeton. Unfortunately, I was disappointed.

Stiglitz served as President Clinton's Chief Economic Adviser and his book can be seen as a partisan justification of the economic policies of that president.

The US economy was already recovering strongly when Clinton took office. Coupled with the significant reduction in defence spending afforded by the collapse of Communism, there was a natural tendency for the budget deficit to improve. The late 1990s productivity miracle was not foreseen by economists, and seems to have resulted from a sudden upward shift in the American population's ability to make effective use of high technology.

Yet rather than a wide-ranging and rigorous analysis of these phenomena, Stiglitz offers the reader a world view concentrated on the Oval Office, as seen by Clinton. Although bond yields fell globally well before Clinton was elected in November 1992, while the recovery of the US banking system from the savings and loan debacle was really the work of Greenspan, dating back to 1990, he attributes the recovery in the early 1990s mostly to improvement in the banking system:

"It was the banks' readiness to give credit that made the real difference, and it was the Clinton Administration's deficit reduction plan, and its inadvertent effect of recapitalizing the S&L's, that got the economy back on track."

The Great Unravelling by Paul Krugman is essentially a collection of his regular columns for the *New York Times* between January 2000 and January 2003. Krugman is an astute observer and articulate critic, and he has written a thought provoking preface and introduction. But *The Great Unravelling* would have been a much better book if the old weekly columns had been dropped and these sections expanded into a complete, if short book. The author is fairly scathing about the 'W Bush' administration, noting the dubious justification for the 2001 tax cut, and the administration's apparent contempt for international law. Indeed, Krugman accuses it of not being conservative in the normal sense of that term:

"It seems clear to me that one should regard America's right-wing movement - which in effect controls the administration, both houses of Congress, much of the judiciary, and a good slice of the media - as a revolutionary power...that is a movement whose leaders do not accept the legitimacy of our current political system." ■

The three books reviewed are available to UKSIP members at the following special prices.
To purchase them visit your online bookshop
www.uksip.org

The Roaring Nineties *Normal price £18.99*

is available to UKSIP members at the special price of **£16.14** *Order code: 19738*

The Great Unravelling *Normal price £20.00*

is available to UKSIP members at the special price of **£17.00** *Order code: 16663*

The Real Warren Buffett: Managing Capital, Leading People
By James O'Loughlin, Nicholas Brealey Publishing, 2003, pp282. £12.99, ISBN: 1-85788-308-X
Reviewed by Colin McLean

Can anything remain unknown about Warren Buffett? Dozens of books are already available - themes include Buffett's secrets, wit and wisdom and investment skills. New publications on the sage of Omaha must fight their way onto bookshop shelves, and demonstrate an original angle. James O'Loughlin's *The Real Warren Buffett* does just that. Rather than offering revelations and secrets, what makes this book work is the stimulating way in which the facts are presented. The author gets to the roots of Buffett's success. Subtitled *Managing Capital, Leading People*, the book sets out the unique way in which Buffett's long-term success is built on some unusual incentivisations.

Many books have focused on analysing Buffett's genius as a stockpicker, but *The Real Warren Buffett* scores on presenting the case for recognising his leadership. There are many insights for investors and managers, and it is helpful that this is interpreted through an author who is an experienced investment manager.

It is also timely, given today's investment environment. Buffett's approach to managing capital is a lesson for all long-term investors. The impact over time of correctly allocating capital - or re-investing dividends - is often understated. Dividends' impact on long-term compounded returns will be even more dramatic as dividend yields rise, and overall economic growth and capital returns remain low. A low inflation, low growth world is the ideal environment in which Buffett's insights should be read by investors.

History

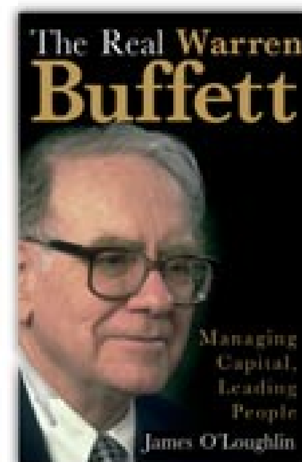
The Real Warren Buffett's ten chapters open with just enough of the history of Berkshire Hathaway and Warren Buffett to show the early problems and the evolution of the winning formula. From there it moves on to explain why Buffett has been so willing to dispense with a strategic plan. The key, however, is that a few simple principles make this seemingly casual behaviour far from reckless. Buffett motivates the business managers to return excess cash to the parent company, but otherwise he gets little involved in local commercial decisions. He genuinely trusts the managers, and his faith has been dramatically rewarded.

Chapter five turns to the insurance industry, which delivers 60% of Berkshire Hathaway's earnings. In a commoditised and competitive sector, Buffett has brought a discipline to writing business that aims to keep losses down when pricing is poor. It was within the insurance business that Buffett stumbled in 2001, with underwriting short-comings and under-reserving. However, this first ever loss for Berkshire Hathaway revealed Buffett as all the more human, and the subsequent turnaround in General Re demonstrated his strengths.

The concluding chapters move on to Buffett's focus on the important and knowable - what he calls the "circle of competence". Buffett's distrust of projections, in favour of detailed analysis of history, is wise advice for all investment analysts. O'Loughlin pulls together his themes, and looks to the future for Berkshire Hathaway.

The Real Warren Buffett is well researched and thought out. If I have any complaint, it is possibly in what at times can be excessive use of italics. These are typically for quotes from Buffett, but risk breaking up the author's flow, when a point is well enough made without any emphasis. Also, the book has a tendency to use Jack Welch as a benchmark of management style, against which Buffett is contrasted. More meaningful comparison would be helpful for readers outside the US or those less familiar with General Electric.

However, these are minor criticisms, which will not limit enjoyment of this book. *The Real Warren Buffett* is recommended for investment analysts, wealth managers and management students alike. ■



Buffett's approach is a lesson for all long-term investors

The Real Warren Buffett *Normal price £12.99*
is available to UKSIP members at the special price of **£11.04** *Order code: 19245*

Co-operation on the Cape

Arthur Thompson and Anne Marie Wood describe how the Financial Analysts Society of South Africa works with the more established Investment Analysts Society of Southern Africa to support the CFA

The big picture

Foreign exchange controls - a legacy of the apartheid era - are still with us but are slowly being relaxed. South Africa has become a prime tourist destination, reportedly the fastest growing in the world in 2002.

• GDP Growth	**3.5%**
• GDP	**$154bn**
• Inflation (CPI)	**4.9%**
• Population	**46.4m**
• GDP per head	**$3,310**

Source: The Economist

The AIMR Board of Governors approved the formation of the Financial Analysts Society of South Africa (FAS) on November 8th, 2001. We started with an initial membership of 90 CFA charterholders and today are approaching 300 members.

The FAS is a "country society" with a presence in both major investment centres, Johannesburg and Cape Town - the former city being the industrial hub of the country and home to the JSE Securities Exchange, the latter, the locus of fund management. The cities are 1,600 km apart by road or two hours flying time, and FAS administration is conducted from Johannesburg.

South Africa is a small but sophisticated financial market with a corresponding corps of analysts to complement the traded exchanges. In 1968, a group of about 30 analysts and portfolio managers got together and created the Investment Analysts Society of Southern Africa (IASSA) (www.iassa.co.za) IASSA maintained its international links, even through the laager-mentality years of apartheid, and has grown in numbers over the years to its current membership of about 2,100.

In 2001 there were 316 AIMR members in South Africa, and the number keeps growing, with 225 CFA Level III candidates passing their exams this year. The total candidate body was about 3,000 and it was this significant number that prompted IASSA, with the encouragement of AIMR, to investigate the formation of a specific society to cater for the specialised needs of this growing group.

Uncomplicated

The relatively uncomplicated formation of FAS in a country with a vibrant, existing society representing analysts - IASSA - can be attributed to the mature approach of both societies, which share the common vision of effectively serving the investment professional and operate a policy of co-operation rather than antagonism and unhealthy competition. There is, in addition, a significant overlap in membership, and the absence of competitor exams to the CFA has helped ensure co-operation.

A significant factor in the formation and effective running of FAS is the opportunity to jointly use the staffed office facilities provided by executive officer, Ann Marie Wood, who fulfils the same function for IASSA. This has allowed the FAS board to concentrate on strategic issues and service delivery. Naturally, this staffed office function is performed on an arms-length basis since each society is constitutionally, legally and financially independent.

We have found the Webcasts on CD a most useful tool, the three or four held annually providing both educational and networking opportunities and drawing attendance in excess of 100 people on each occasion. Our three annual CFA Introductions are aimed at Level I candidates and attract interested parties from business and universities. We have also held breakfasts where guest speakers, local or international, have addressed our own and IASSA members.

The FAS is currently running candidate preparatory courses and there are other third-party courses available to candidates. We were delighted to learn of AIMR's scholarship programmes and have awarded three bursaries in 2004 to deserving candidates whom we anticipate will become a credit to the profession.

Our board members are enthusiastic, forward-thinking volunteers from multi-disciplinary investment backgrounds and all - Andrew Canter, Michael Collins, Warwick Langebrink, Arthur Thompson and Andrew Warren - are charterholders. We have no doubt that the South African society will go from strength to strength. ■

Arthur Thompson is FAS president and an executive committee member of IASSA. Email: AThompson@tsec.co.za

Ann Marie Wood is executive officer of FAS and runs her own consultancy, which offers a similar service to IASSA. Email: iassa@iafrica.com

DAVID SMITH

The inflation danger from China

China, as everybody knows, is becoming a dominant player in the global economy. Long-term projections from Goldman Sachs show that in three years time China's gross domestic product will have overhauled that of France, Britain and Germany. By 2020, China will be bigger than Japan and during the 2040s larger than America, and thus the world's biggest economy.

However, it may be that China's path towards matching her economic importance to her huge population of 1.3 billion is not quite as straightforward as that. But we do not, in any case, have to wait 40 years for a demonstration of China's significance.

In 2002, the Chinese economy grew by 8% - a typical rate of expansion - and in doing so contributed no less than 36% of global economic growth. Last year, China again boomed (as it has done, more or less, since the late 1970s), with growth this time of 9.1%. In a stronger international environment, China's global contribution slipped slightly. But it was still equivalent to a third of total world economic growth. The global economy, plainly, has been tilting towards the east.

China, still for the moment only the world's sixth largest economy, is a voracious consumer of raw materials, accounting for between a fifth and a third of global consumption of aluminium, iron ore, zinc, copper and stainless steel.

It would be wrong, however, to think of China as merely a consumer of large quantities of commodities. Volkswagen sells more of its vehicles in China than in Germany. General Motors is increasing Cadillac production by 50% to cope with demand from China's new business elite. And this is merely scratching the surface of the country's emergence as a consumer on a huge scale. After all, gross domestic product per capita in China is only a twentieth of average levels in the European Union. Real incomes are set to grow hugely, and rapidly.

If all that makes China the most exciting story of the world economy, it also raises one or two worries. Given the fact that China is already emerging as a dominant player, these worries fall into two related categories.

The first relates to the sustainability of the Chinese boom and, in particular, the consequences of any bursting of what could be an economic bubble. As China has become the world's leading recipient of foreign direct investment, the reverberations of a sudden economic cooling, let alone a crash, would be felt around the global economy.

The second relates to the effects of the boom itself. Commodity prices have been rising sharply in world markets. This is partly a consequence of the weak dollar, as producers have sought compensation for the US currency's weakness. But it is mainly due to rampant Chinese demand for raw materials. Many metals and other commodities stand at their highest level for a decade, and have risen particularly strongly over the past year or so.

Not only that but China itself is emerging from a long period of deflation and is experiencing inflation again. Food prices are showing annual rises of 9% to 10%, while general inflation is closer to 3% but is rising. Higher food prices are not necessarily a bad thing in China, because they have the effect of redistributing income to the rural poor, but they underline the re-emergence of inflationary pressure.

So how big are the risks? The investment boom is of legendary proportions. This is an economy bent on building for the future, to the point that investment has risen to more than 40% of GDP. This raises the spectre of over-investment, something rarely seen in Western economies, but typical of Asian countries ahead of the Asian economic and financial crisis of 1997-98. Thailand, Singapore and Malaysia all had investment-GDP ratios of around 40%.

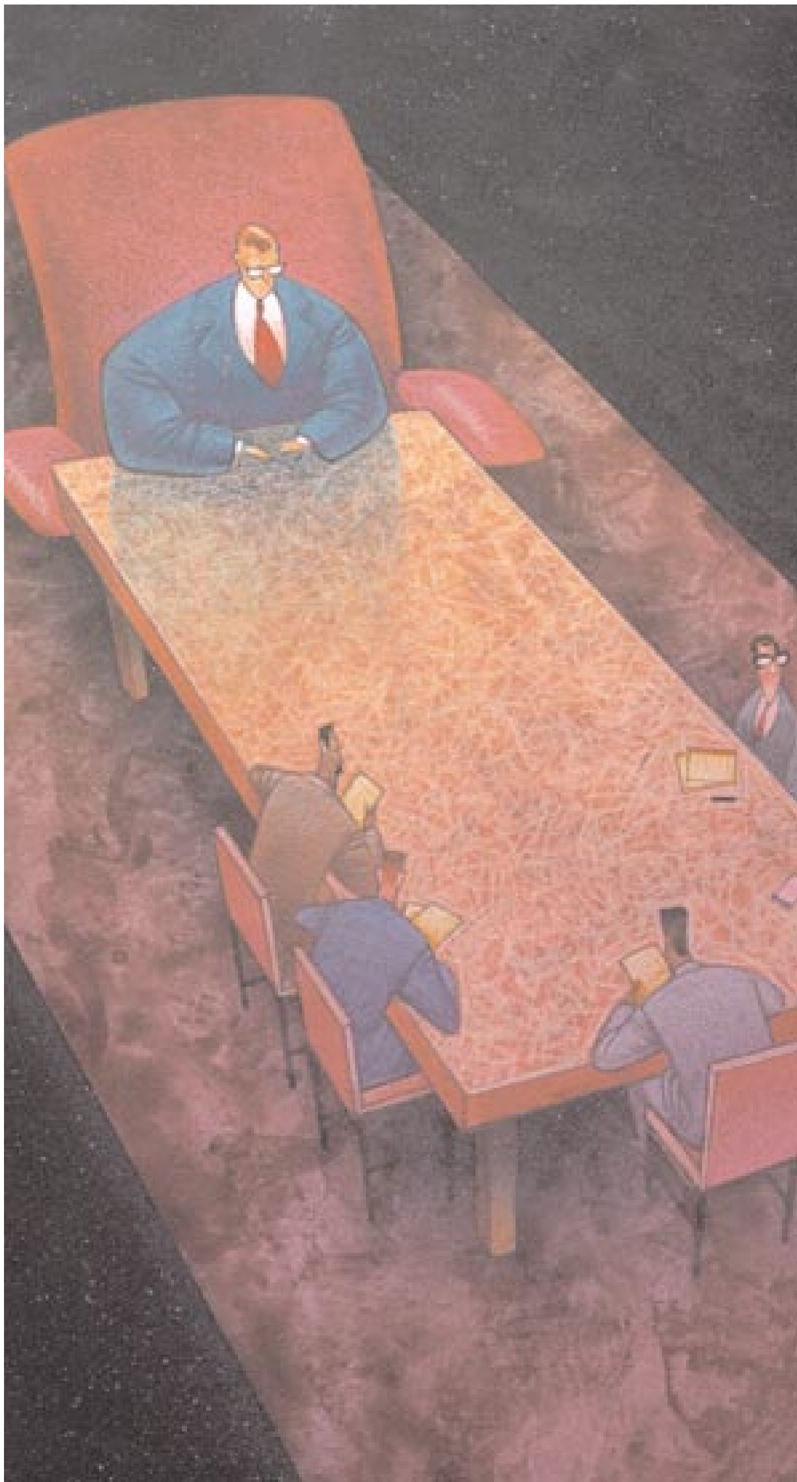
So how big is the risk of a Chinese economic accident, with nasty knock-on effects elsewhere? While it is tempting to draw parallels between China and the Asian economies of a few years ago, it is also unnecessarily alarmist. For one thing China's sheer size means its capacity to absorb large amounts of foreign direct investment is enormous. In addition, the Chinese authorities are in far greater control of events than the governments and central banks of the smaller Asian economies.

Neither rising commodity prices nor the re-emergence of inflation, however, should worry us too much. Commodities, even oil, do not have the impact on inflation that they used to, because western economies have become less industrial, and therefore less sensitive to shifts in raw material costs. As for Chinese inflation, it is only necessary to go back to the mid-1990s for a time when prices were rising at a 25% rate, without affecting the benign global inflation environment. A much smaller rise in inflation is in prospect this time, and the effects outside China will be minimal.

Indeed, it may be entirely the wrong thing to look for inflation from China. For the past decade the China effect has been deflationary, through lower prices for industrial products. That effect has not gone away. Low-cost Chinese production will continue to help keep a lid on global inflation. ■

David Smith is the economics editor of *The Sunday Times*. Visit his website: www.economicsUK.com

The prospects for privately owned businesses



Why private equity firms play such an important role in the development of SMEs in the UK, explains Chris Rowlands

While large corporations dominate the financial pages, small- to medium-sized enterprises (SMEs) are the real engines of the UK economy. Businesses with fewer than 250 employees provide 56% of jobs in the UK, according to the Department of Trade and Industry (DTI). Research from the Manchester Business School in 2002 indicates that 75% of all companies are owner-managed, and these alone produce 50% of GDP.

Together, these SMEs have helped keep Britain out of recession, even as large corporations were rocked by share plunges and corporate governance issues. Including sole partnerships, the country actually added 51,000 new businesses in 2002, according to statistics from the DTI.

SMEs have also delivered a more robust performance than their larger counterparts in recent years. They are more productive: for example family owned businesses have a greater sales turnover per employee than large corporations, according to 2002 research from Barclays Bank. SMEs themselves believe they have the edge in customer service, innovation, product quality, quality of workforce and cost efficiency.

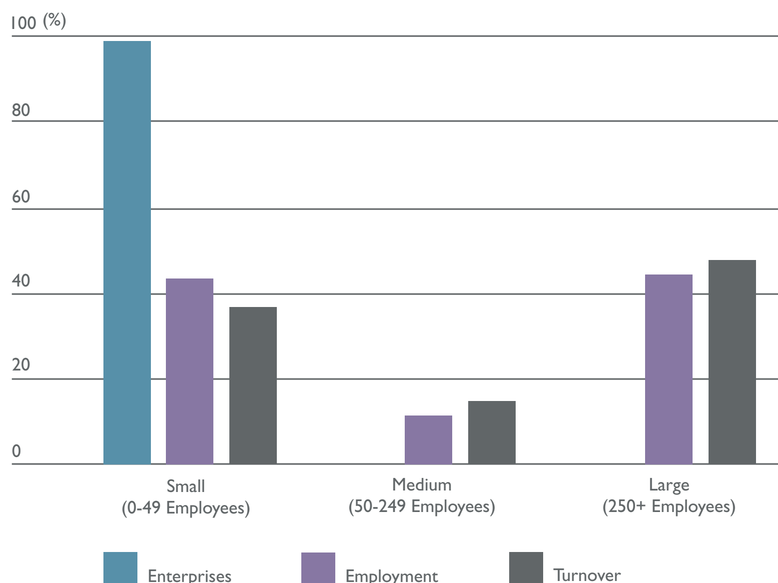
These competitive advantages will enable many SMEs to consistently outperform their larger rivals. Smaller, nimbler businesses also

have an advantage in fast changing markets, and are often better at managing a single brand than their larger rivals. The long-term prospects for privately owned business are also more favourable now than they have been for many years. The Economist Intelligence Unit, for example, forecasts a return to more robust growth in UK GDP of 2.3% in 2004, while three other factors create a favourable environment for expansion:

Interest rates have been at one of the lowest levels since the 1960s. 'Taper relief' on capital gains ensures that proceeds from most business sales will be taxed at just 10%, providing privately owned companies build tax efficiency into their planning.

Evidence of hiring and investment for growth from larger corporations remains modest. That leaves private business more room for manoeuvre. This combination of natural advantages and a favourable business climate mean prospects are good for well-managed privately owned companies.

Chart 1: Smaller size. bigger impact
Share of business, employment and turnover, by size of business in the UK



Source: Small and medium-sized enterprise statistics, Department of Trade and Industry, 2003

Bridging the investment gap

Despite the importance of privately owned business to the UK economy, SMEs often struggle to maximise growth and value creation. Companies reach a stage where relying on debt alone to fund expansion is no longer appropriate, yet a stock market flotation remains beyond reach. Private equity has a valuable role to play in bridging this investment gap.

A number of privately owned businesses have used private equity to fund growth, finance acquisitions or release capital. But generally private equity is under-utilised as a source of capital. Only 4% of all private equity transactions completed in the UK were sourced from family/private businesses in 2002, up by 1% from 2001. So why aren't more SMEs taking advantage of private equity?

Access to capital in the form of private equity has improved in recent years. There are also a lot of misconceptions about how private equity works. These misconceptions include the belief that private equity firms are focused on short-term returns; that they will interfere with the running of the business; and that they are poorly represented outside London.

In reality, these perceptions are often inaccurate. Private equity firms often operate from a local level, which gives them a better understanding of the unique requirements of privately owned business, so they tend to tailor their products and services accordingly.

They are also active investors - in the sense that they will act as partners rather than simply lending money. This doesn't mean they will force owners to hand over the keys to new management, however. However if there is confidence in the existing management team, investment in them will continue to help deliver success. The partnership approach is the right solution depending on the specific circumstances of the business. This greater flexibility is enabling more and more privately owned businesses to take advantage of the private equity market.

Debt versus equity

Many privately owned businesses rely solely on debt to fund their development, as we have seen. One reason is debt is perceived as a lower risk option than private equity, but in many instances this view is misplaced.

Debt is a sensible way to fund development to a certain point, but there comes a point where the scale of debt adds an extra level of risk. By sharing risks and rewards with a private equity partner, companies can take on more ambitious projects and accelerate value creation for their stakeholders.

Some owner-managers believe borrowing enables them to fund growth while retaining full

Private equity firms often operate from a local level, which gives them a better understanding of the unique requirements of privately owned business

control of the business. This is true up to a point, but if a project goes awry with a high level of debt, companies can very quickly lose control. This is a particular issue for privately owned companies, where borrowing may be secured against personal assets.

Ultimately the choice between private equity and debt is more than a financial decision. Private equity firms offer a package of business networks, industry expertise, and experience of value creation. The large equity houses' significant experience of managing hundreds of acquisitions and sales every year makes them useful allies for owner-managers on the road to expansion.

Solving the funding challenge is a major step towards realising your company's ambitions

Tax and reward

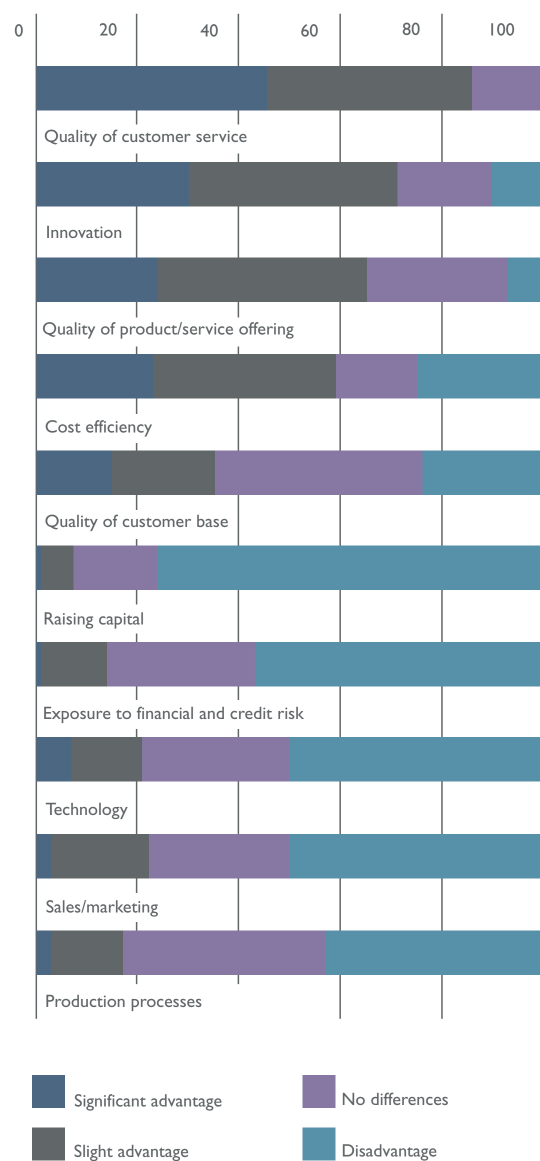
There are a number of opportunities to maximise the tax efficiency of private equity funding, and a good private equity deal is structured to ensure it falls into the safe harbours where tax is minimised. Tax considerations are also important for owner-managers planning their exit strategy. People expect the proceeds of a sale to be subject to 10% tax under taper relief. The rules governing taper relief are complex and change on a frequent basis. Expert advice can help companies ensure capital gains arising from a sale are taxed at the optimal rate.

Companies need to plan for these issues as early as possible, since it is difficult to correct mistakes retrospectively. They also need to recognise that tax legislation is going through significant changes. The lesson is, don't assume past knowledge is necessarily accurate.

Managing for value

Solving the funding challenge is a major step towards realising your company's ambitions, but there are other challenges to consider. Owner-managers that want to maximise their company's potential to deliver personal wealth should focus on value creation, not just profitability. Value in this sense is what is left

Chart 2: Competitive edge



Source: KPMG Mid-Market Survey, 2003

when the founders leave the business - for example, brand, customer relationships, culture and intellectual property.

Value creation is as much about business processes as personal relationships. This is a challenge: few entrepreneurs have an appetite for procedures and recordkeeping, and most rely on informal relationships with employees and suppliers. But as their companies grow, a lack of structure can become damaging. A good private equity partner can help companies identify the

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standards and controls that entrench value within the business.

Change at the top

For many privately owned companies, business change means personal change. A successful entrepreneur may have all the right qualities to take a company up to a £10 million turnover. But making the transition to £50 million or £200 million often demands a very different type of management team.

It can also be argued that owner-managers need to assess their strengths and limitations objectively. This is never easy, but benchmarking the management team against successful companies outside your own sector can help identify skill gaps. In others, owner-managers elect to step aside for a new CEO or managing director with more appropriate skills for the challenges ahead.

Devolving control can be difficult on a personal level, but the key is to make the decision that will enable the company to move forward.

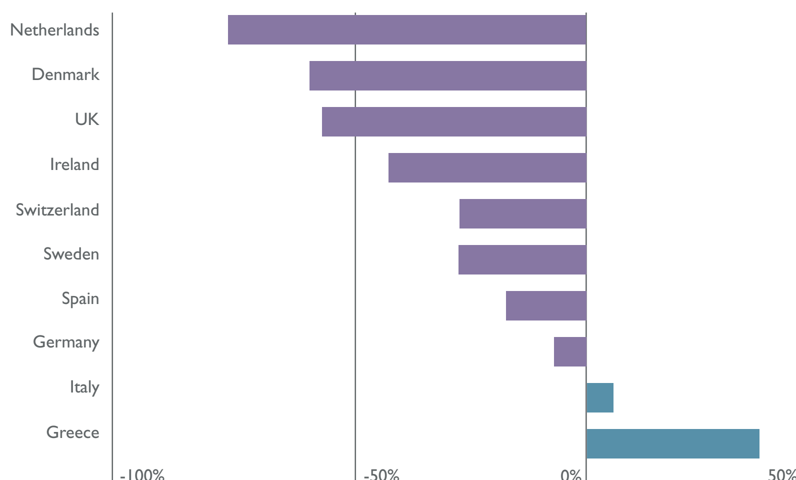
Succession and stability

Succession is one of the most challenging times in a company's development. It is particularly difficult for family-run companies, where succession can pit brother against brother. Despite these issues, 60% of family business owners have not thought about succession planning or what will happen to their business when they retire, according to 2002 research from Barclays Bank. When asked about succession in a recent survey conducted by PRIMA, most family owned business managers in the UK felt their companies should recruit from outside the company.

Finding the right successor is a major task in its own right. They also need to offer the right package to attract exceptional talent. Privately owned businesses are understandably reluctant to dilute their shareholdings, but offering attractive share options can be key to attracting top quality management.

The transition to new management is a delicate time. Even where the incoming CEO is highly gifted, their entry into a family owned business creates challenges for all parties. The biggest risks arise in the first three months, where personality clashes between the new CEO and the owners can be hugely damaging. Often these difficulties arise because the owners are reluctant to relinquish executive control.

Chart 3: Should management successors be chosen from the family?



Source: PRIMA survey of European family-owned businesses, 2003
The percentage balance is between respondents who answered yes minus those that answered no.

Though the succession process is a testing time for many companies, bringing in professional management can multiply the potential rewards from your business. Objective advice can also help companies clarify their goals and plan an effective exit strategy.

Private equity: value beyond capital

Growing a business, funding ambitious projects, planning an exit strategy - these are vital turning points in a company's development. The challenges should not be underestimated, but there are huge rewards for owner-managers who get it right. Pursuing growth with the help of a strategic investor can make a business more stable, broader in its market vision, and more valuable.

In addition to an injection of capital, private equity houses offer the experience, expertise and business networks that can help privately owned companies realise their full growth potential. What no outsider can bring, or wants to damage, are the qualities of creativity, adroitness and dedication that launched and nurtured the business in the first place.

Grafting on a durable, value-building structure without quashing entrepreneurial spirit is the apogee of the art of modern management. It's an area where support from a well-connected investor can make all the difference. ■

To contact 3i: email nurturingvalue@3i.com

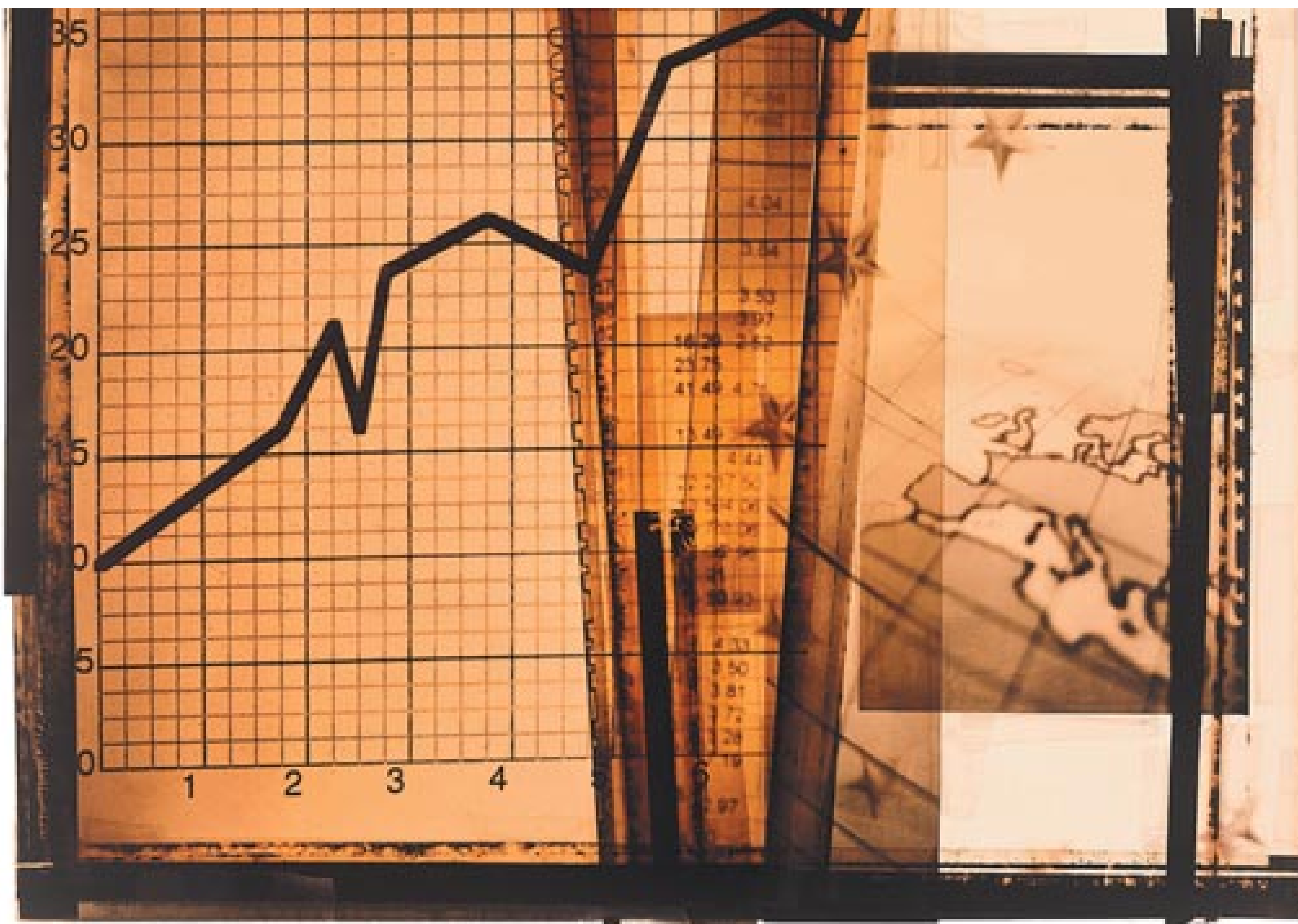
On file...

AIMR Body of Knowledge III
Professional Investor

■ **June 2004**
The "Neglect Effect" (Smaller UK Stocks)
John Borgars

■ **March 2003**
Getting off the ground with good governance (in IPOs)
Igor Filatotchev

■ **April 2001**
Small Caps: Thinking small
Robert Treich



The outlook for European private equity

Helen Steers and Colin Wimsett explain that the long-term perspective for the business is far more upbeat than the gloomy short-term reports

When the European Venture Capital Association (EVCA) produced commentary on the preliminary 2003 activity figures for European private equity, the association suggested that annual investment is 'stabilising somewhere around the €25 billion mark'. In fact, investment approached nowhere near this level until 1999, when the €25.1 billion total invested represented a leap of more than €10 billion from the previous year's figure.

Of course, 1999 was the real beginning of the market's bubble phase. A year later, European private equity fundraising soared to within spitting distance of €50 billion, while a profligate €35 billion was invested - and since when, received wisdom has it, it has been downhill all the way. Well, perhaps not quite: investment levels are, as suggested, trending towards the €25 billion mark over the past three years and, war stories of a dire fundraising environment in the past couple of years notwithstanding, annual fundraising totals remain above the €27 billion mark.

So the fluctuations in levels of European private equity activity have clearly been far less dramatic than the turbulence experienced by the public markets. Why then has the general mood remained so gloomy? Much of the negative sentiment that has prevailed is attributable to the experiences of the (many) investors who made their first foray into the asset class right at the market's peak, seduced by the prospect of short-term returns that most experienced investors recognised as being unsustainably high, at a time

when many new, untested managers were entering the market. Predictably, one-year and three-year performance numbers for private equity fell off a cliff shortly thereafter.

But to judge the long-term asset class of private equity on such short-term numbers is to make a fundamental error. The argument for the inclusion of private equity within an investment strategy hinges on the proposition that it should deliver outperformance of conventional asset classes, and quoted equities in particular, over the long term. Pantheon Ventures, which has more than 20 years' experience of private equity fund investment, is confident that this will remain the case going forward.

However, performance varies dramatically between individual private equity funds, even within the same geographic and investment areas. Manager selection is therefore of critical importance to investors in the asset class and requires specialist expertise in private equity due diligence. Success depends on the ability to select managers with sustainable strategies to outperform over the longer term and is therefore at least as much about understanding the changing nature of the landscape as analysing past performance. The ability to judge what the expected returns from a projected strategy should be and whether a particular manager can 'beat' the average for their peer group is key to private equity investment outperformance.

Because of the long-term and illiquid nature of individual unquoted investments, private equity is not an asset class that lends itself to market timing - as those investors who piled into the market during the bubble phase found to their cost. At Pantheon, we have always advised clients to build steadily towards their target allocations to private equity over a period of several years. Confusingly, however, much of the market commentary produced by the private equity industry itself focuses on relatively short-term factors influencing the climate for investment.

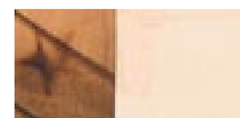
In this context, it is vital to make a clear distinction between the function of the Limited Partner in this equation - a strategic decision to invest in the asset class and to build towards their target allocation steadily over time - and that of the General Partner, which encompasses both the readiness to capitalise on a benign climate for new investments when such a blessing is available and the discipline not to invest when the time, or the opportunity, is not right. (Given that historically, later-stage funds formed during recessionary periods have outperformed their non-recession counterparts, the identification of a benign climate for private equity investments can be something of a counter-intuitive exercise.)

When considering the outlook for European private equity, therefore, an investor should not focus on transient market conditions but instead consider the structural factors influencing opportunities for investment over the longer term.

Perhaps the most striking of these is the extent to which the European private equity market remains underdeveloped in comparison with the much more mature - and more homogeneous - US market. The potential for further growth in scale for European private equity is illustrated by the differential between the US and European markets in terms of private equity measured as a percentage of GDP: the 2002 figure for the US was 0.6%, compared with an average of 0.28% for Europe as a whole. Furthermore, since competition in Europe is not yet approaching the levels of some of the highly competitive private equity market segments in the US, the potential to earn superior returns remains high.

There is therefore considerable potential for further expansion of the European private equity market, despite the rapid growth it has experienced in recent years. Several of the factors that have driven this growth continue to apply:

- **Deregulation and restructuring.** Europe has been experiencing a period of significant economic, political and industrial change that is continuing to expand the opportunities for private equity investing. Following the introduction of the euro, the economic cycles of the key countries are converging, the development of European capital markets has accelerated and industry has continued to deregulate and restructure at an



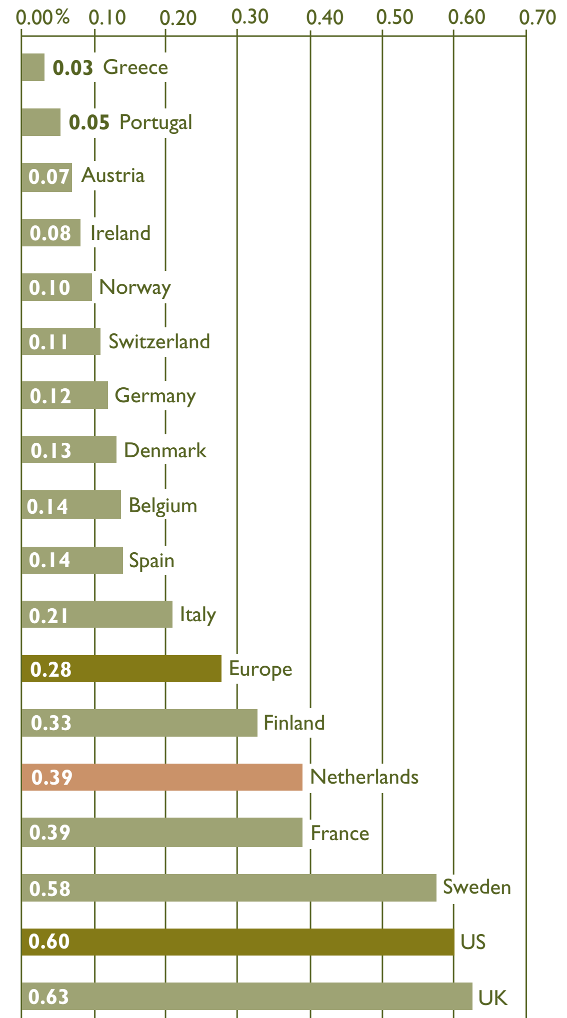
An investor should not focus on transient market conditions but instead consider the structural factors influencing opportunities for investment over the longer term

Helen Steers is a senior member of Pantheon Ventures' European investment team, with principal responsibility for primary investing. Helen joined Pantheon in 2004 from Russell Investment Group in Paris, where she was managing director with overall responsibility for Private Equity in Europe. Prior to joining Russell in 1999, Helen spent five years as Director, European Private Equity with the Caisse de dépôt et placement du Québec. From 1989 to 1994, Helen was the senior investment manager at the Business Development Bank in Montreal. Helen has an MA in Engineering from the University of Cambridge and an MBA from the University of Western Ontario in Canada.

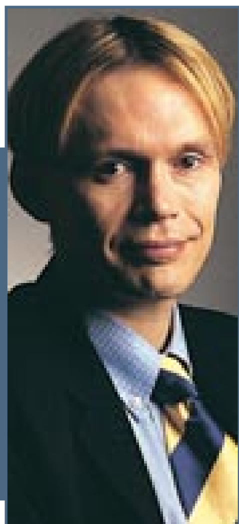
Despite the global and political turmoil since 2001, the European private equity market has remained buoyant

unprecedented pace. The European industrial landscape is being redrawn and private equity investors are uniquely positioned to profit from this transformation. Given that conglomerates currently represent approximately the same proportion of corporate activity in continental Europe as they did in the US in the late 1980s, the opportunity for restructuring remains extremely significant.

- **Closer economic integration and globalisation.** The 15 existing member countries of the EU form an important economic region with a population of 380 million and GDP of €8.9 trillion. In addition to the major structural changes triggered by closer economic and financial integration and the introduction of a common, single market, businesses in Europe are being affected by technological change and by the development of an equity culture. At one end of the spectrum, European conglomerates have been forced to rationalize to compete effectively in a deregulated and unified common market as well as on the global stage. At the other end of the spectrum, traditional family firms have had to confront generational change and the need for regional consolidation. Furthermore, the EU will be expanded by the accession of ten new member countries in May 2004. GDP growth in the new member countries is expected to accelerate to approximately 3.8% in 2004, and the inclusion of these economies within the single European market provides increased opportunities for corporate expansion and industrial restructuring.
- **Increasing maturity of the European private equity market.** This dynamic environment has helped to accelerate the growth of the European private equity market over the past few years. Until 1997, the level of both fundraising and investment activity was relatively modest in Europe. Since then, a wave of mergers and acquisitions across the European industry has stimulated the growth of the buyout business in Europe. Numerous groups have now raised private equity funds in excess of €1 billion and both funding and investment levels have been on the rise. Despite the global and political turmoil since 2001, the European private equity market has remained buoyant.
- **Broadening of the continental European market.** The UK continues to lead the European market with the deepest and most mature private equity industry in Europe, with many groups now raising their fourth or fifth successive funds. The French and German private equity markets have both developed considerably over the last ten years



Source:EVCA



Colin Wimsett is a senior member of Pantheon Ventures' European investment team, with principal responsibility for primary investments. He is a member of the International Investment Committee. He oversees all areas of Pantheon's European business activity. He joined Pantheon in 1997 from the West Midlands Pension Fund, where he spent nine years focusing on private equity investments. Colin has a BA in Economics from the University of Reading and is a chartered banker (ACIB).

but still retain significant potential for further expansion. Italy and Scandinavia, like the UK, have generated extremely attractive historical returns. While the Nordic market is now relatively mature, Italy's private equity market is still underdeveloped in relation to the size of the Italian economy and therefore retains significant growth potential. Other small but significant markets which provide a regular flow of quality transactions include Spain, Benelux, Switzerland, and Ireland. Central and eastern Europe has a developing fund manager population but currently lacks the depth or maturity of the core European private equity markets.

While the US is the largest, most mature and developed private equity market, the strategic importance of Europe is steadily increasing. With established economies, welcoming to private enterprise and providing a stable institutional framework with sufficient critical mass in terms of fund managers and deal flow to allow sustainable fund management businesses to develop, Europe offers diverse opportunities for private equity investment.

In parallel with the structural factors driving the growth of opportunities for private equity, the nature of the European private equity market is changing. The polarisation of the European buyout market between large pan-European funds and mid-market operators is continuing. This polarisation is a key factor influencing both the organisational models of general partner firms and investor approaches to strategic allocation. The outlook for European venture capital in the near term is less clear, but the market still generally lacks institutional quality. Despite a widely held belief among investors that the European technology sector is under-funded at present, the flow of capital into this market segment is likely to be constrained in the near term by the challenges of manager selection, the influx of new entrants to this sector during the bubble phase having muddied the waters considerably.

The Goldman Sachs International/Russell Investment Group's *Report on Alternative Investing 2003* reveals the extent to which European investors have revised their relative appetites for management buyouts and venture capital since 2001.

The ongoing debate over valuation, transparency and disclosure will be a significant force in shaping the private industry worldwide in the coming phase. Achieving true transparency at the fund level is crucial if private equity is to become truly established as a mainstream asset class. It is equally important that a clear distinction be drawn between fund transparency and transparency at the portfolio company level, which is potentially deeply damaging for private equity and which the industry must take steps to avert. Industry groups on both sides of the Atlantic are increasingly committed to achieving realistic global standards for valuation and disclosure, as befitting to a mature, mainstream institutional asset class.

In the short term, Europe can expect a positive deluge of new private equity fund offerings in 2004/5, coinciding with the widespread uplift in market sentiment that is now making itself felt. This development highlights the necessity for investors to develop strategies based on long-term investment cycles. The risk of private equity investment can be mitigated through diversification at the portfolio level. There are many elements to consider when building a diversified portfolio, including geography, investment stage, sector focus and management style. But above all, investors in private equity should remember that appropriate diversification can only be achieved by steady investment over periods of several years, thus mitigating the risk of exposure to any particular phase of a market cycle, and not by annualised commitments.

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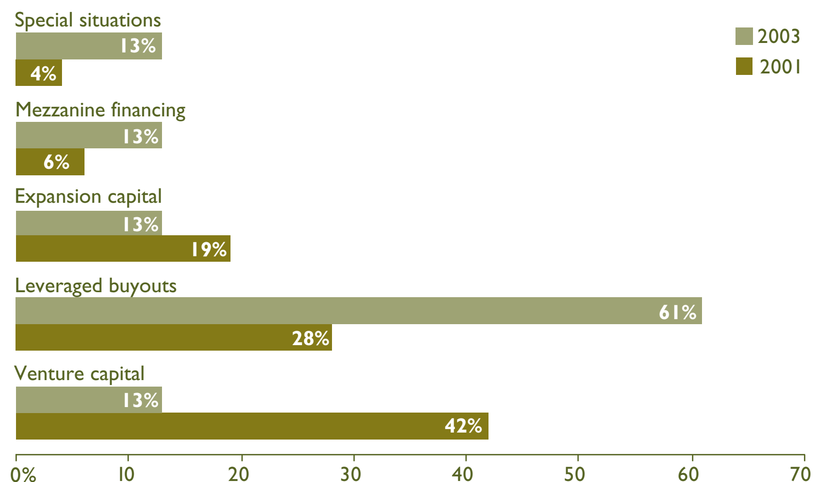
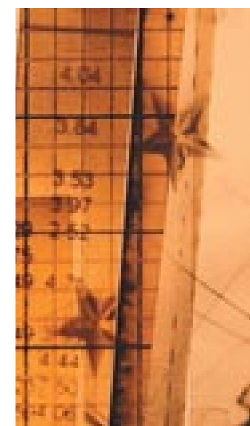
Chart 2: European investor demand for private equity investment types over the next three years



Source: Goldman Sachs International/Russell Investment Group



On file...

AIMR Body of Knowledge III

Professional Investor

June 2004
The "Neglect Effect" (Smaller UK Stocks)
John Borgars

March 2003
Getting off the ground with good governance (in IPOs)
Igor Filatotchev

April 2001
Small Caps: Thinking small
Robert Treich

The climate for private equity investing

Simon Wildig characterises the market as changeable in the near- to medium-term

The prospects for the UK private equity market could best be described in that vague term used by weather forecasters when they want to hedge their bets: 'changeable'. If you were to take a poll of private equity practitioners' views, they would probably say that times have been tough over the past couple of years. Deals are taking longer to complete; volumes are down; prices are up; and exits have been difficult to come by. Predicting what comes next is not straight-forward. To gauge the prospects for the immediate future it is worth dwelling for a moment on the events that led to the current market conditions and the impacts that result.

Following a significant ramping-up of fund-raising activity in the late 1990s, UK private equity houses were pregnant with cash for investment and were investing at a rapid rate. Most of the recent malaise can be put down to the fall-out following the events of September 11 and the continuing uncertainty of increasing terrorist activity. There's also the lingering effect of the technology crash and the accounting scandals post-Enron. The combination of these factors contributed to a crash in the quoted indices 18 months ago, since when major corporations have been nervous about what to do next. After a prolonged period of M&A activity to re-focus on core activities, many were gearing themselves up for the next round of acquisitions when the markets fell. This resulted in a notable drop in M&A activity. For private equity houses and leveraged finance providers under pressure to put their investors' money to work, deal flow has been sporadic. Consequently, there has been a lot of finance chasing a limited number of good investment opportunities.

And yet, comparing current deal activity with the situation 12 months ago, the picture has been relatively encouraging. The volume of Europe-wide management buyout (MBO) activity increased by 40% during 2003, outperforming the general growth in M&A, which was approximately 20% for the same period. Private equity is continuing to take an increasingly large share of the merger market and, in the UK, it's accounting for more than 50% of all transactions. Looking at value, it translates into about 15% growth in the value of the UK MBO market for last year which, in aggregate, was worth €28 billion.

The UK economy, despite concerns about rising consumer debt, is also fairly robust and has performed well. It's doing significantly better than the German and French economies, the euro has gone in our favour in the last few months and UK businesses are holding their own against the competition. And, if the aggregate UK private equity portfolio is a reasonable proxy for the economy as a whole, then it should be in reasonable shape provided it is not over-geared.

There is a concern that base rates will rise to over 5% in the next 12 months, but consensus opinion amongst forecasters suggests that it is not this, but a major house price recession that threatens to dent UK consumer confidence and impact economic prospects. This does not seem likely in the near term.

So, on the whole, the prospects are encouraging. There's plenty of money available for investment and the corporations are gradually coming back to the market with more M&A activity. Stock market growth has been slow but gradual and the list of upcoming and potential IPOs is longer now than it has been for the past three years.

An extension to the recent stable market conditions should see more M&A volume and hence greater private equity activity - but it will be gradual - we don't expect to see a return to the heady deal volumes of the late 1990s which were driven by technology fever, but that is a good thing.

Increasing portfolio size

The relative inertia of the past two to three years has created a separate issue for private equity houses - the ballooning size of many venture

capital portfolios. The trend is a consequence of the number of new investments being completed in the last ten years not being matched by a similar number of exits and the subsequent growing age of investment portfolios. In the last 10 years, there have been over 1,400 management buyouts completed in the £10 million-plus sector, but only 600 exits.

The reduction in the number of exits in recent years means that venture capitalists have been forced to hold on to investments for longer. The average length of an investment has now risen to over five years, compared to just three years in the early 1980s. The effect of this increased length of investment means that only 30% of three- to four-year-old investments and only 50% of four- to five-year-old investments in the £10 million-plus buyout market have been exited.

Issues surrounding ageing investments have been compounded by the ever-larger funds venture capitalists have raised to invest in new buyout opportunities. The question is, what issues arise as a result of ballooning venture capital portfolios?

Management of portfolio companies

The main effect of the ballooning size of portfolios on people within the venture capital community is, that they have to spend an increasing amount of time monitoring investments. This time constraint is not only due to the increasing number of portfolio companies, but also because additional time is required to nurture successful investments in the current uncertain economic climate. It is also important to recognize that, as an investment ages, it becomes even more important to ensure that equity value is still being created each year rather than simply being maintained or even eroded.

Some venture capitalists employ specialist portfolio managers to take responsibility for a portfolio investment after a deal has been completed. A recent survey by KPMG Corporate Finance suggested that this was a growing trend. However, many, including ourselves, still believe that it is important for the original dealmakers to remain involved and indeed to remain accountable for their investments.

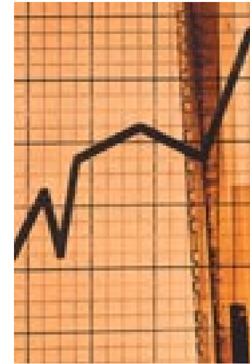
For those dealmakers involved in managing portfolio investments it is now believed that up to 40% of their time can be spent monitoring and managing portfolios, a 10% increase on last year. This time commitment puts increasing pressure on the ability to source and complete new investments, and again could be compounding the decreasing trend in the number of new investments being made.

Achieving the exits

The only way to reverse the new trend of increasing portfolio sizes is to exit more investments. Where are the exits going to come from?

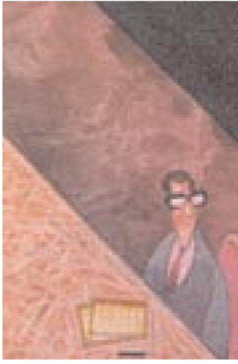
The current trend in exits varies between different markets. The £10 million to £100 million mid-market has seen a reduction in the number of successful exits, with recent CMBOR data showing a decrease of just over 10% since 1998. This reduction compares favourably to other sectors of the venture capital market and is due to the decrease in the number of trade sales. The reduction in the number of trade sales and increase in secondary buyouts has been well documented. However, a more notable trend is the shift in the method of obtaining an exit, with secondary buyouts now accounting for over 50% of successful exits within the mid-market compared to just 20% in 1998. Trade sales now only account for 40% of successful exits, compared nearly 70% in 1998.

The markets for LBOs under £10 million and for those over £100 million have different characteristics to the mid-market. The under £10 million market includes a greater percentage of receiverships, which now account for over 50% of all exits. This level of receiverships is almost double that in the mid-market. The number of successful exits in the under £10 million market also shows a bleaker picture, with a decrease in volume of 35% between 1998 and 2002, compared to a decrease of around just 10% in the mid-market. Again, this decrease in the number of exits is due to the reduction in trade sales. Also, as in the mid-market, secondary buyouts have now become a fundamental exit



In the last 10 years, there have been over 1,400 management buyouts completed in the £10 million-plus sector, but only 600 exits

Simon Wildig is a partner of Close Brothers Private Equity (CBPE). He is an accounting and economics graduate, and a chartered accountant who qualified with Deloitte in the early 1980s. He joined CBPE 10 years ago and became a partner in 1996. He has held board seats on a number of companies including, most recently, SP Systems, Tractiv Group and Hillarys Blinds. Simon is one of a team of 13 at CBPE that focuses on the UK middle market with a deal size between £10 million and £100 million. CPBE recently closed their seventh private equity fund with £360 million.



The key future trends that will affect the size of mid-market venture capital portfolios are the number of trade sales and the number of secondary buyouts

On file...

AIMR Body of Knowledge III
Professional Investor

- **June 2004**
  The "Neglect Effect" (Smaller UK Stocks)
  John Borgars
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  Igor Filatotchev
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  Small Caps: Thinking small
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route for this market, accounting for over 40% of successful exits.

The market for LBOs over £100 million has shown the most positive exit characteristics with the number of successful exits nearly three times their 1998 level and double their 2001 level. The mix in the type of successful exits has remained relatively unchanged, with 50% from trade sales, 25% from flotations and 25% from secondary buyouts. Receiverships have remained at a low level since 1999, accounting for less than 10% of total exits.

Reversing the trend in portfolios

This analysis shows that along with the general health of the economy, the key future trends that will affect the size of mid-market venture capital portfolios, are the number of trade sales and the number of secondary buyouts.

The general market trend of a decrease in the number of trade buyers has not been evident throughout the UK mid-market. At CBPE for example, during the last year the portfolio has remained at a relatively constant size with 24 investments. This is a result of five sales in the last year and four new investments. A breakdown of these exits shows that 80% were via trade buyers and 20% were via secondary buyouts. An analysis of the trade buyers shows 75% were to large central European businesses and only 25% were to UK businesses. The key, therefore, to the decrease in the number of trade buyers in the wider market, may be due to a lack of UK and US trade buyers. Once these buyers re-enter the market it may bring the resurgence in exits awaited by many in the wider UK mid-market private equity community.

While the UK and US trade buyers have remained on the sidelines, the venture capital community has had to re-evaluate how it can exit investments or return cash to investors if full exits are not achievable.

Secondary buyouts have historically been considered by many venture capitalists as the least preferred option, as they did not believe that these deals deliver the highest value. However, recent deals in the UK mid-market have shown that secondary buyouts can deliver an excellent return for the outgoing venture capitalist on their investment, and even surpass the price some trade buyers are prepared to pay, with multiples of just over eight times earnings before interest and taxes (EBIT) being paid.

Nevertheless, we do not want to see re-financings or secondary deals as the main source of private equity exits in the medium term, as the inherent conflicts are obvious. We need to see trade buyers returning to the market in greater numbers and there are definitely signs that this is already happening.

Value is only realised when an investment is exited and PE practitioners should now be focusing more attention than ever before on portfolio management and exit grooming. At CBPE we have had a policy of commissioning detailed exit reports as part of pre-investment due diligence. These are presented to investment committees before the deal is done, so that the business is positioned for the most appropriate exit opportunities at the earliest possible stage.

We also make use of a stable of "serial" entrepreneurs to chair or lead executive management teams for us. These individuals are experienced businessmen, but more importantly habitual money-makers with their own networks of contacts.

Not only do they help source transactions for us, but they actively manage the businesses we invest in with the exit in mind. They help instil the shareholder value ethic in the minds of the senior management of the business, so that a unified way of thinking is transmitted through all levels of the team; and they play an active role in identifying potential buyers and nurturing relationships with them. We have found that this technique, rather than the cold, programmed, auction process, delivers best value when we exit our investments. The buyer will, after all, feel more inclined to pay a premium, strategic price for a business if he has had the opportunity to get to know it over a 12- to 18-month period before he signs the cheque.

Conclusion

Ballooning portfolios in the UK mid-market maybe a recent trend, but they are the logical result of an imbalance between new investment and exit volumes over recent years. The key to reversing this trend is to achieve more exits. Exits may be more readily achievable when UK and US trade buyers decide to adopt a less conservative and more expansionary stance again. However, there may be ways to facilitate exits that are more within the venture capitalists' control. Detailed pre-investment market appraisal and more pro-active portfolio management are the keys to unlocking optimal valuations for businesses. ■

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The pros and cons of 'unbundling': *two comments on CP176*

Jamie Stewart recalls developments to date and assesses the likely impact

When CP 176, the FSA's Consultation Paper on Bundled Commissions, Soft Commissions and Transparency, was published almost a year ago it prompted plenty of discussion in the fund management and broking communities. Since then the FSA has announced its preferred way forward, by way of pre-emptive statements made by its CEO, John Tiner, at a recent CBI meeting, as well as a full and formal announcement in May.

The FSA's policy is to transfer responsibility to investing institutions - the buy-side - that will agree and report on procedures to be implemented with a view to ensuring that the regulator's list of essential measures are built into standardised working procedures.

The FSA appears to continue to see protection of retail investors as paramount, and at the same time wants to ensure that dealing commissions are whittled down to a minimum. It will accept and ratify an industry solution reflecting this objective if submitted in complete form by December; otherwise the authority will take up the stick itself and impose a regime of its own design without further ado.

Agreement

After CP176, it was broadly agreed within the industry that it is cheeky for a fund manager to make his clients pay for the basic tools of his trade without which he could not have drawn them to him in the first place. Most saw sense in saying that if you spend clients' money, it is right that they know how much you are spending and on what you are spending it; that you are getting good value for money, and that what you buy should work as far as possible in the end investor's direct best interests.

It followed naturally that one should seek clients' permission in advance for the ways in which their money should be spent, and that the acceptable core of such expenditure should consist only of competitive, high quality trading execution and of the research services that help form the decision as to what trades should be committed. Most considered it right that "commission dollars" should be properly and clearly negotiated, explained and allocated. In short, people woke up, compared ideas, saw the light and began to face in one and the same direction.

Clarification

In response, John Tiner clarified the regulator's position. He recognised - to a point, in principle and on the basis of bespoke research - the dangers of excessive severity driving capital and therefore business offshore: the "regulatory arbitrage effect" that could theoretically see global, integrated fund managers move the domicile of their vehicles offshore.

The FSA, he said, will "give the industry space to develop and trial a solution based on improved disclosure", and will assess progress in December. Meanwhile, he saw "some regulatory change as appropriate to set the right framework", suggesting that merely shuffling the papers and reaffirming the cub scouts' oath and code of honour will not be deemed enough.

This last cryptic comment begs the question as to what those changes might be. We surmised all along - and are since pleased to note - that tightening and re-definition of traditional soft commission may feature, as may recognition of systems and agents operating with authorisation

If it seems that we are breathing down the industry's neck on this issue, that is because we are

John Tiner

to act as introducing and funding brokers; norms to ensure that client mandates, articles of incorporation, trust instruments and the like address the need to inform - if not predicating authorisation from - clients as to application of their money.

Perhaps the requirement that brokers set up and display clear menus with dishes, recipes, ingredients, origins and prices as a basic component of Terms and Conditions will emerge. This path had been (and is still) the subject of heated discussion among global and integrated brokers, the common sense and propriety of the objectives clashing violently with their excesses, accounting quirks, subsidies and non- or counter-competitive stances and procedures in evidence since Big Bang, over 15 years ago.

The FSA clearly intends that "fund managers' use of clients' commissions should be limited to the purchase of trade execution and of investment research", while emphasising the need for disclosure "to separate out the payments for execution from those for research" and for "the emergence of an explicit market price for research."

So "bundling" is dead; long live "unbundling"! And nanny will step in again if, as has been decreed, by end-December, the industry's proposed steps to implement enhanced disclosure are deemed insufficient or ineffective. The FSA will seek regular progress reports and will continue to "review the governance of retail funds."

'Cosiness'

The regulator clearly continues to dislike the perceived "cosiness" between fund managers and the boards of many of the vehicles they manage.

At the other extreme, it has been made increasingly clear that while pension funds and investment trusts are top heavy with boards of directors, certain other pooled and collective retail funds have none.

Cadbury, Higgs, governance, ethics and accountability have set thousands of cats amongst millions of pigeons, and there are blood and feathers everywhere - just look at the split-level trusts; unit trusts, UCITs and OEICs; their similarities, differences, variations in levels of non-executive-type protection of the retail investor.

Tiner ended his April address to the CBI Financial Services Council meeting with the sternest of nursery admonishments: "The ball is now very much in the industry's court. If it seems to them that we are breathing down their neck on this issue, then that is because we are."

So what will follow? The industry has no option but to unbundle: goodbye opacity, hello transparency and accountability; declare and disclose for all you are worth - and client permission acquires divine status.

The trick, after commending the slickness, fairness and good sense of it all, endorsed by the latest FSA announcement, is to predict which stings lie in which tails and whom they will poison.

- Scenario 1: Margins in broking and fund management, already under severe pressure from various effects and impacts, will be further eroded - directly and indirectly - by this cleaning-up operation and by the costs entailed to bring about and maintain the squeaky-clean status quo of the future.
- Scenario 2: Therefore some failures? Hopefully not.
- Scenario 3: Even more consolidation in both segments, leading via piously preached economies of scale and benefits of reach to lower levels of competition, higher levels of monopoly and to US, Japanese and other "super" banks taking control of our home-grown brokers and asset managers.

- Scenario 4: Homogenisation, the economies of scale cited above, needs for consistency and pressurised margins lead, in addition, to further commoditisation of an industry that has been steadily forfeiting many of its levels and qualities of personal service, of performance, of style, of leadership and of evolution for years already. This cannot possibly be good for the UK's leading position in the global industry - worse yet, it may not actually stand the small investor in very good stead either.
- Scenario 5: Notwithstanding recognition of the likely benign end-effects of CP176, some operators will stamp their feet, sulk and reach for the option of regulatory arbitrage. You don't need many portfolios to emigrate from here to less strict climes to bring about a capital drain as well as the brain drain that will inevitably accompany it.
- Scenario 6: Some brokerages will be obliged by commercial factors to compensate for revenues foregone as a result of unbundling. There are precious few ready remedies available to them. One is the insidious move towards widening spreads in prices of stock traded net by market makers. This scenario is compounded by the danger that the recourse could not exist in a few isolated instances; it is more likely to be adopted as a common measure, countering perceived market efficiency and raising considerably the "hidden trading costs" borne by funds.

Options

But there is no need to become obsessed with toxicology. Try reaching for the serum, for the inoculations. With any luck there will be some healing and some health-giving options once the scorpions have been dispatched to the herpetarium.

Among them:

- Benefit 1: An Augean cleansing of the stables of middling research and analysis. The tale, dead dreary by now, is that too many traditional, sell-side analysts:
  (i) are in business;
  (ii) were subsidised by primary business flows, are now in the balance of the books and will weigh on margins if they are left intact in the future;
  (iii) generate same-ish, turgid stuff which is closer to post-mortems than ideas;
  (iv) cheat;
  (v) are made to tell fibs by their overlords;
  (vi) are neutered by house style, house stance, book positions, corporate-client-focus and the filtration-plant in the office of the head of research; and
  (vii) lead to distortion of salary scales, too often leading indirectly to exerting a monopoly over the employment tribunal chambers at Woburn Place.
  When it becomes necessary to rationalise them, reprice them and price their product reasonably, then you, I, Joe, Jane and all investors will regain some confidence and even advantage.
- Benefit 2: The natural recourse to in-house, buy-side analysts will resume its growth, jolted by the bear market and constrained by the market distortions created by traditional, proprietary research. Such buy-side R&A teams are geared to their own clients, their own funds and their own fortune and misfortune in a far more palatable, straightforward and profitable mix.
- Benefit 3: Independent research entities, bearing virtuous watchwords as their mottos and excellent work fashioned through competition, price-sensitivity and the drive to succeed as small businesses, will have a more encouraging climate in which to work.
- Benefit 4: Hedge funds - for all the disparaging asides born almost exclusively of envy - will find ways to make the changes work for them, not against. They make money, they set high standards, they proliferate, they employ and they wither and die if they are not competitive and not successful. The nature of their structures, status and style is such that post-CP176 will by and large prove a benign climate in which to flourish.

At Eden Group, we recognised early on the limitations of traditional proprietary research, offering independent research intermediation as a core service platform to investing institutions. We believe that this closely fits the bill that the FSA - and the industry - are designing. Eden was intimately involved in the formation of the Association of Independent Research Providers, and remains equally closely involved in its structure and operations. We applaud the objectives of the FSA and what lies ahead; we are believers in the qualities and values that Tiner has indicated will emerge from CP176. ■

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Notwithstanding recognition of the likely benign end-effects of CP176, some will stamp their feet, sulk and reach for the regulatory arbitrage option

Richard Szwagrzak reflects on the problem of how to attribute costs fairly among clients

The lowest possible commission isn't the only measure of a deal

The FSA wants to change the way some investment managers obtain market data and research. Currently, many receive these services from brokers as an incentive to trade with them, by way of soft commissions. Proposals that the FSA is now considering would make investment managers pay for their data directly. So what would this mean for managers and their clients?

In September 1998 AIMR published its own Soft Dollar Standards, beginning with the simple statement: "Brokerage is the property of the client." AIMR went on to state that the investment manager has an ongoing duty to ensure the quality of transactions effected on behalf of its client, including seeking to obtain best execution, minimising transaction costs and using client brokerage to benefit clients.

Obtaining best execution means getting the best deal for the client. The lowest possible commission isn't the only measure of a deal. Often the broker is a source of trade ideas, or a supplier of in-house research or third party services like Bloomberg. A particular broker may have access to buyers and sellers not available to others. Sometimes the choice of broker may be influenced by the decision to maintain a spread of relationships, to keep options open in the future.

Services

As AIMR put it, the investment manager should make sure that over time all clients receive the benefits of services purchased with client brokerage. For a client to benefit, they must assist the investment manager in the investment decision-making process. The client must have given consent to the expenses being incurred at the commencement of the relationship.

AIMR's position recognised that there need not be a direct relationship between commission generated and benefit gained, but that in return, full disclosure would be made by the investment manager of both commissions paid and services purchased. This was also the FSA's position, more or less, at the time.

Now, in its paper, the FSA questions the fairness of brokers charging commission at a rate that prices in the cost of research services that may not be used to benefit the client directly. Instead, the regulator proposes that the range of these services be restricted, or additional consent and disclosure be required, or both. According to this viewpoint, investment managers' clients will benefit from paying less commission and the managers will have one less potential conflict of interest. Additional services may be purchased separately, if required, and paid for by the investment manager.

Transparent

Many clients have consented already to the investment manager buying research or market data out of brokerage generated on their account. These clients expect to benefit from these services, and implicitly expect to pay for them. An outcome of a regulatory change might be to prevent these clients from spending their own money as they choose.

In this event, some investment managers might raise their fees, while others might agree to bill their clients directly for services used in the investment decision-making process. The second outcome has the advantage of being transparent, although the client may still end up paying the same.

But practical problems do remain. Much has been written about the difficulty of cost attribution for the providers of bundled research services. But investment managers billing directly for these services would face the problem of how to attribute costs fairly among their clients. This may require some managers to invest in new accounting and administrative systems.

So how will the client be sure that they are being billed fairly? Might not unscrupulous managers seek to line their pockets with inflated charges?

In practice, investment managers paid mainly by performance fees would have little incentive to over-charge their clients. Any short-term advantage would quickly be countered by poor performance, redemptions and loss of fee income. And the hedge fund industry is more than sufficiently competitive to weed out those managers with below-average performance. ■

Richard Szwagrzak is the chief financial officer and chief operating officer at Trafalgar Capital Management Limited with responsibility for risk management, finance, operations and compliance. He is a member of the editorial board of Professional Investor*, the journal of UK Society of Professional Investors.*

On file...

AIMR Body of Knowledge I
Professional Investor
■ **November 2003**
Getting it right (Clients' interests)
Ian Thomas
■ **November 2003**
Transparent commissions: case not proven
John Rogers, Jim Fleming
■ **June 2003**
Revamping the ISD
Maggie Stoker

Liquidity and risk

Colin Lizieri describes new research into the determinants of liquidity in the commercial property markets

In examining the qualities of real estate as an investment asset, "illiquidity" is a frequently cited disadvantage. Institutional, professional and private investors express concern at the lack of liquidity or require higher returns in compensation.

Much of the justification for new property investment vehicles - such as REITs - comes from their ability to enhance liquidity. Surprisingly, there has been very little research into such a key concept.

This brief report summarises key findings from a research project on liquidity in commercial real estate markets, funded by the joint research programme of the Investment Property Forum (IPF) and IPF Education Trust. The research was completed in February 2004. The research team, drawn from three leading universities and from IPD, was supported by a strong IPF steering group.

The broad aims of the project were to provide an overview of research on liquidity in real estate markets and to provide preliminary empirical analysis of liquidity and turnover in property and other capital markets. The project was intended to act as a foundation for further research studies on property liquidity in the future.

We examined four aspects of liquidity:

- What is liquidity; how do concepts of liquidity from other financial markets fit commercial real estate?
- What evidence is there on the relative liquidity of different asset types?
- How long does it take to sell a property investment and what causes delay?
- How does liquidity affect the riskiness of investing in real estate?

Understanding

We conducted a literature review, analysed property transactions and the sales process and built statistical models. The main findings are set out below.

Most people in property have an "intuitive" understanding of liquidity. However, closer examination shows that usage varies. Liquidity is a complex, multi-dimensional concept, which captures much more than the time taken to execute a trade. Liquidity also includes:

- The costs, direct and indirect, of trading;
- Risk and uncertainty concerning the timing of the sale;
- Risk and uncertainty concerning the achieved sale price;
- Trading volume and frequency;
- The price impacts of the act of sale and purchase.

The importance of these dimensions of liquidity will vary across asset classes and, within property, by type of building, sector and location. Importance will also vary according to market conditions. It is thus not possible to have a single, portmanteau definition of liquidity.

From bond and equity market literature, the emphasis is on pricing impacts of trading. Five main aspects of liquidity are used to characterise markets: the cost of liquidating a portfolio quickly; the ability to sell without affecting prices; the ability of prices to recover from shocks; the costs of selling now rather than waiting; and transaction costs - the direct and indirect costs of trading.

These apply largely to public traded markets where depth and the presence of market makers ensure that adjustment to supply and demand occur through the price mechanism. They are relevant to investment property nonetheless.

Property's high transaction costs drive longer holding periods (which in turn may lead to inefficient portfolio allocations). Given thin trading, a fund attempting to sell out of property may suffer losses due to forced sale values. Large investors shifting their property weightings may influence prices.

Property prices are sticky and change slowly. A major difference in direct (private) property markets, however, is that adjustments to changes in supply and demand occur as much through transactions volume and time to trade as through shifts in values and prices.

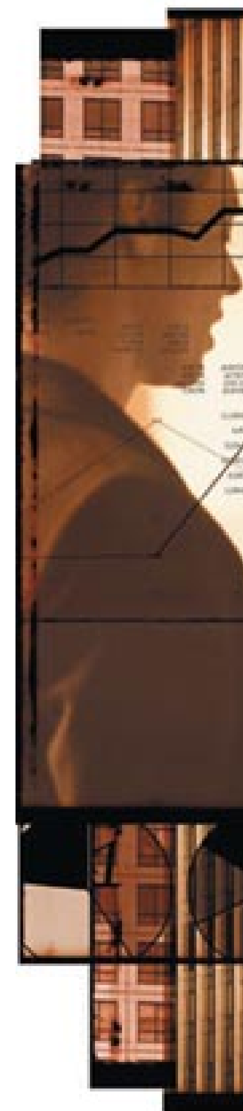
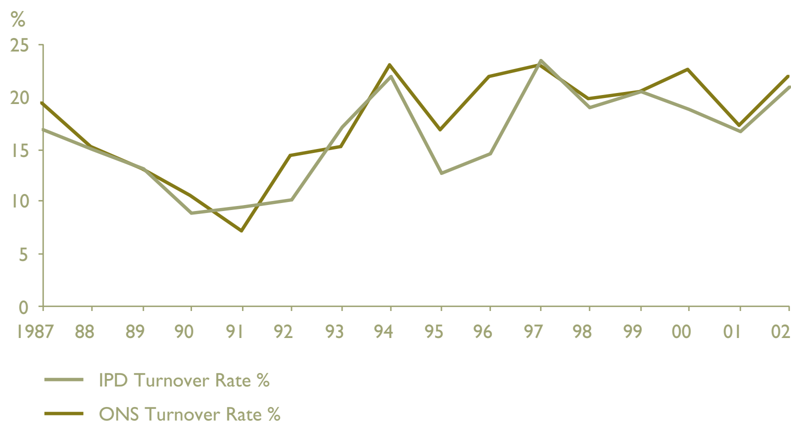
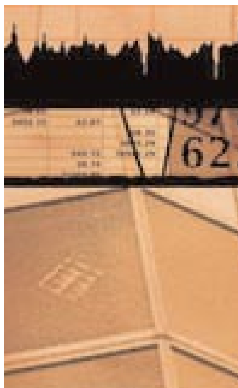


Figure 1: Turnover Rates 1987-2002





There may be a return premium for shares that are systematically more liquid

A key issue in liquidity studies is whether there is a liquidity premium - that is, whether or not investors are compensated for the costs and uncertainties of trading. Evidence for stocks suggests that there may be a return premium for shares that are systematically more illiquid and when markets are particularly illiquid.

Transactions

The rates of sales and purchases provide invaluable information on the relative liquidity of different assets and different market conditions. There is no single ideal database for analysing commercial property transactions. The research used data from the Inland Revenue, ONS, IPD, ARAS and Property Data to analyse UK direct market activity. We also examined activity in indirect property markets and in other countries.

Activity rates in the commercial, investment grade market are considerably higher than for smaller private deals and in the residential markets. Inland Revenue figures suggest that around 5% of the non-residential stock turned over in 2002. Institutional turnover was around 12-15% suggesting a median holding period of around six to seven years.

Activity levels are cyclical but have been trending upwards from the early 1990s at around 3% per annum (see Figure 1). Much of the variation in activity is explained by stock market yields and property market returns. Surprisingly, it is hard to see a significant impact from Stamp Duty increases - although this may be masked by the increased use of special purpose vehicles, in part a response to Stamp Duty changes.

Activity varies by lot size, by type of property and by geography. Many of the variations would be expected: high value property trades less frequently, lower lot sizes (standard shops, smaller offices) are more liquid. There are surprises, however.

In particular, Central London offices trade less frequently than other segments. The total volume of activity is high - providing transparency and comparable information - but the rate of sale is lower than in regional markets.

UK commercial property trades more frequently than property in other countries in Europe. In 2002, the transaction rate was double that found in France and the Netherlands. In indirect markets, UK property companies show greater liquidity than US REITs or Australian Listed Property Trusts - interesting, given the prospects for a UK REIT structure. Since these tax transparent vehicles are aimed at retail investors, buy and hold strategies may be more common. For similar reasons, Limited Partnerships and PUT units trade less often than direct property holdings.

Timing

The ability to enter and exit the property market depends on how long it takes to buy or sell. In the research, we examined the sales process through three case studies - a major property company, and two institutional investors, a life insurer and a pension fund, both with large property portfolios. Interviews were used to examine the sales process, then around 200 sales records were used to estimate typical times on the market.

All three funds applied a pre-sales filtering process. Properties that had a high risk of failure to sell were not brought to market. Once a decision to sell had been reached, most finally sold: there were few abortive sales. However, many factors could delay the sale. These included solvable problems such as tenant disputes, imminent rent reviews and lease terminations and unexpected events - tenant insolvency or default, for example.

Most delays occurred at the due diligence stage. Factors included discovery of inherent problems, changes in market conditions or shifts in the purchaser's intentions. It was felt that use of debt by the purchaser increased the likelihood of delays. Properties that were "ready for sale" were less likely to be affected by delays, but there was a cost in maintaining all

stock in such a state.

It was suggested that periodic valuations might not always fully reflect the true saleable condition of the property. This, in turn, could cause delay if the offer price was below the prior valuation.

On average, the average time from formal marketing to completion was nearly ten months. This figure is misleading as the distribution of sales is heavily skewed, with a small number of sales taking a very long time. The median time to sale, at 190 days, is a more representative figure. That still represents six months to sell the typical property from the funds examined. The longest stage is the period from initiation to heads of terms (median 88 days). Due diligence averaged 62 days while the typical time between exchange and completion was 19 days. These averages hide considerable variation in time on the market.

The sales process is lengthy and complex. Although many properties sell readily and (comparatively) swiftly, unexpected shocks can cause major delays both before and after heads of terms. Streamlining seems to have reduced the final settlement period somewhat.

Risk

The length of the sale process and uncertainty as to the timing of sale adds an extra layer of risk for an investor contemplating a property acquisition. This risk in entering the market - the ex ante risk - will be larger than backward looking risk measures reported by IPD and others. Valuation-based returns do not consider possible delays and losses in realising capital value, while the sale data is known with certainty for transaction-based returns.

It is possible to model this additional risk facing the new investor. To do this, we need information on the distribution of times to sale, data on the volatility of property values and the expected holding period of the investor. The additional risk factor will depend on these three variables:

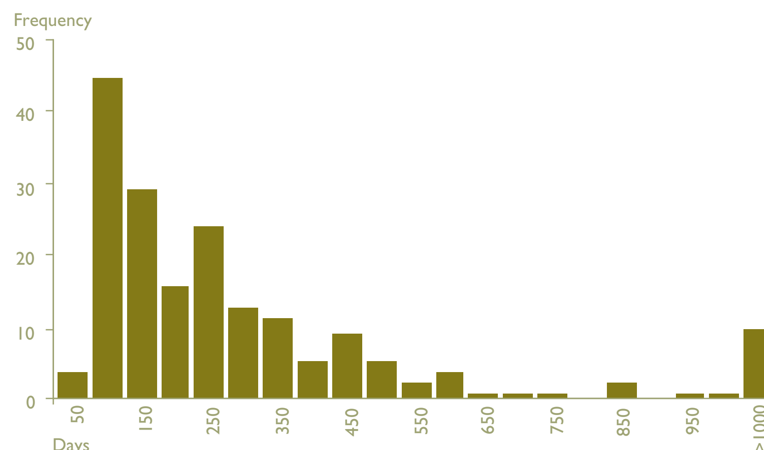
(a) The shorter the holding period, the greater the additional risk;

(b) The more volatile are asset returns, the greater the additional risk;

(c) The longer the time to sale, the greater the additional risk.

For highly liquid public-traded assets, where time to sale is very short, the additional risk is trivial. For an illiquid asset with a long holding period and potentially lengthy time to sale, the extra risk factor may be large.

Figure 2: Time to sale, case study funds - total length of transaction



Using the time on market data from the case studies and IPD market volatility, an investor with an expected holding period of seven years and an asset with an expected time to sale of six months faces a risk factor of 1.38. Ex ante risk is 38% above the conventional reported measure. For a five year holding period and eight months to sale, the risk factor rises to 1.98 - ex ante risk is doubled. For longer holding periods and easily sold properties, the additional risk is minor.

Additional risk factors reduce as an investor diversifies

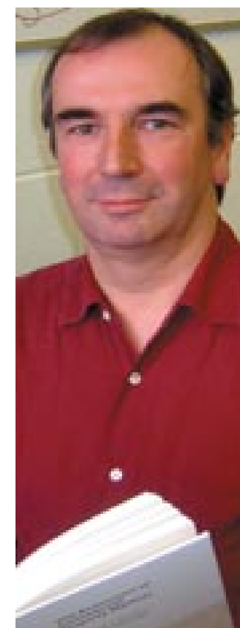
These preliminary findings are important in helping us understand the nature of risk - particularly in the context of finite life private equity vehicles. The research shows that the additional risk factors will significantly reduce as an investor diversifies by building up a larger portfolio.

Springboard

The IPF Research Study was preliminary in nature and intended to act as a springboard for future work. In order to improve our understanding of liquidity, a number of practical tasks could be pursued:

- Regular transaction reporting by the major data providers;
- Improved data on the size of the investible market;
- Improved data on activity levels in indirect property vehicles;
- Collection of data on the time taken to buy and sell property.

This would greatly improve the data and aid decision-makers and analysts. It would also



Colin Lizieri

On file...

AIMR Body of Knowledge IX

Professional Investor

November 2002
Real Estate: Thank heavens for real estate
Selwyn Jones

February 2001
Should direct property exposure be international?
Andrew Schofield

enable more focused research into commercial property market liquidity. Possible future research questions include:

- Can we explain variations in transaction activity?
- Are certain types of property more likely to be traded?
- If so, why?
- How do market structures and attitudes influence the sales process?
- What are investor expectations about holding periods and risk?
- What are the costs and penalties associated with illiquidity?
- Is there a property risk premium for illiquidity?

Some of these tasks are relatively easily accomplished. Others require greater industry cooperation, development of improved datasets or lengthy, resource-intensive research. We hope - and believe - that the IPF Liquidity Study will form an important foundation for this developing research agenda. ■

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Full results of the Liquidity in Commercial Property Markets project are set out in five working papers available from IPF, 3 Cadogan Gate, London SWIX 0AS, (ipfoffice@ipf.org.uk, 0207 334 3799) price £150. Alternatively, a copy of WP5 is available, price £50.

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MARKET VIEWPOINT

Is the US recovery already peaking?

Tony Plummer thinks that it is, the only question being whether the decline is slow or fast

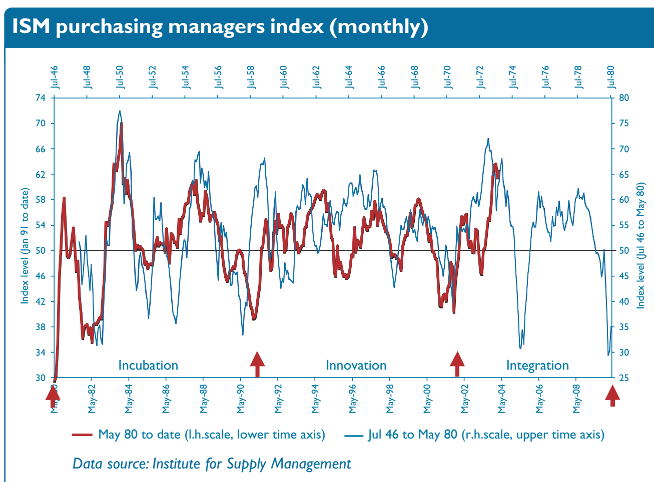
Economic theory accepts the influence of economic cycles. Unfortunately, the best-known cycles (such as Joseph Kitchin's three to five year inventory cycle, Clement Juglar's seven to 11 year capital investment cycle, or Brian Berry's 25 to 35 year infrastructure cycle) have widely variable periodicities. So, although the cycles may descriptively be useful after the event, analysts often have great difficulty using them for forecasting.

The periodicity of a cycle is, however, only one consideration. The other is its underlying pattern. This pattern, which derives from group behaviour, has two important characteristics. First, the pattern allows for the fact that all evolving systems need to conserve energy in order to delay entropy. So, all human systems require periods of 'rest', and they need to harmonize with other systems in order to minimize total energy usage. Recessions and bear markets are therefore essential parts of the process of economic evolution, and the associated rhythms are harmonised.

The second aspect of cyclical patterns follows from this. The harmonisation between cycles takes a specific form, whereby each cycle contains three sub-cycles. Hence, three Kitchin cycles constitute one Juglar cycle, three Juglar cycles harmonize with one Berry cycle, and so forth. Moreover, each sub-cycle exhibits phase-specific characteristics. The first cycle in a triad deals with an adjustment from on old set of circumstances to an evolving new set. The second cycle actively incorporates new ideas. And the third cycle is used to bed down the resulting changes. There is a three-stage progression through incubation, innovation and integration.

This description is only one perspective on a complex phenomenon. Nevertheless, we can directly compare the evolving pattern of a current cycle with ones that have occurred in the past, and then anticipate what might happen next. Below is a chart showing movements in the US Purchasing Managers' Index calculated by the Institute for Supply Management (the ISM index). The index tracks producer expectations over two 30-year Berry cycles - July 1946 to May 1980, and May 1980 to (roughly) early 2010. The former period includes the 1958-70 cycle that embraced the move to mass consumption; the latter period includes the 1991-2001 cycle that facilitated the main thrust of the infotech revolution. Both periods therefore cover Juglar cycles of economic innovation.

ISM purchasing managers index (monthly)



Data source: Institute for Supply Management

The art here is to align the 30-year cycles such that the major turning points in the underlying ten-year cycles are synchronized. Once done - by measuring the time elapse of each cycle on a separate axis - it is quite clear that there is a close correspondence between the patterns. In other words, the major cycle lows are determined by a combination of periodicity and pattern. Hence, the economic recovery since late 2001 has broadly matched the recovery that took place between late 1970 and early 1973. Moreover, the ISM index has now moved out to the highest level for 20 years, just as in 1973 the index moved out to the highest level for 18 years. In both cases, the new burst in enthusiasm occurred, not during powerful innovation cycles, but subsequently when the authorities were (for whatever reason) stimulating the economy. Another parallel: now, as then, the new highs in the ISM index are being accompanied by an explosion in commodity prices.

But what happens next? The integration cycle is usually the most difficult because it has to eliminate some of the excesses of the previous innovation cycle. In 1973, a quantum leap in oil prices was added to rising interest rates and, in 1974, the US economy fell into a deep recession. In early 2004, there has not yet been either a comparable economic shock or a rise in interest rates. So negative growth is not inevitable in 2005. But the obvious conclusion from the analysis is that the US economy is now transiting a natural inflexion point. The only issue, therefore, is whether the forthcoming deceleration will be slow or fast. ■

Tony Plummer is a director of Rhombus Research Ltd. E-mail: tcp@rhombusresearch.com

Drinking wines too young

Hugo Rose bemoans the lack of patience among some wine drinkers, while identifying some new world gems

Photograph by Catriona Dickson

Hugo Rose

Where are all the old vintages of Australian, South African or Chilean wine? This question is prompted by two recent tasting experiences, which demonstrate just how good these wines can be if allowed to age gracefully in proper cellar conditions. The first, a 1994 bottle of Australian Riesling from Henschke in the Barossa Valley, north of Adelaide was quite beautiful; it had a true bouquet of flowers and fruit and just the right hint of fragrant oil, somewhere between melted butter and lanolin; the finish was long and expressive, with a neat crisp lemon-like cut which seemed to keep everything in its place. Ten years old, a joy to drink and no sign at all of going to seed. The second was a red wine, a Cabernet Sauvignon from 10 years earlier still, this time from Penfolds. The 1984 Bin 707 was at its limit but it still acquitted itself admirably, with a fine mellow, pencil-shavings and spice note, and a smooth palate with a good dry finish.

We in the wine business are understandably proud of our jewels, and perhaps equally understandably dismayed when they are maltreated. Another common complaint is that the best wines are drunk too young and largely in restaurants. We know how well the wines age, we try to educate our customers, but they insist on breaking the unwritten code and pulling the corks far too soon.

For decades we have drunk the wines faster than they have been produced and there is an element of the North Sea cod problem about this. Just as over-fishing has resulted in smaller, younger fish on average, so over-drinking has led to the average age of bottles coming down. And there are other forces at work: the market tries to clear its stock every year to make room for the next vintage and few producers (outside Spain) or merchants are inclined to invest capital in stock to build up the reserves necessary to allow us to enjoy fine older bottles at will.

In the case of fine wines from Europe, the situation is marginally better than for the new world. Decades of cellaring, of trading at auction and of broking has created a market for older bottles and the stock to go with it, and for the determined buyer a good range can be had - at a price. What is not possible is for a large number of customers to switch to older wines: there are just not enough to go round, hence restaurants, even very good ones, have to make up their lists with ever-younger vintages of the best wines.

But with the likes of Australian wines, the prospect of searching out the great older vintages, like the two I mentioned at the start, is barely an option. The number of bottles still in circulation of even five-year-old Cabernet or Shiraz is miniscule. There has not been the same culture of producers holding inventories, of merchants building up stocks and of individuals creating cellars for their future enjoyment. One reason is that, as much of the wine industry in most new world countries is recently arrived, the benefits of maturing wine have not been appreciated.

Which new world wines will stand the test of time? Like European wines, the answer is not the mainstream of commercial production, much which is at its best pretty well straight after shipment. But like European wines, there is a hierarchy of quality, a pyramid with a number of jewels at the top. And, like those European wines a number are white, such as the Riesling I mentioned. I have also chanced upon some wonderful 10-year-old Semillon (look out for Hunter Valley examples), western Australian Chardonnay and Verdelho, and even Sauvignon Blanc; a truly memorable 10-year-old example of this latter came from South Africa (made by the Klein Constantia estate, if I recall correctly), none of which retailed for much above £10 a bottle. With reds the list is, if not endless, at least extensive. Barossa Shiraz (look out for Henschke), Yarra Valley Cabernet, New Zealand Pinot Noir (the 1994s remain sensational), Californian Cabernet and Zinfandel.

The march of new world wines suggests that it will be a canny buyer who cellars a little more of these wines than they drink, building up even a modest cellar with which to impress their friends in a decade's time. ■

Hugo Rose, Master of Wine, is head of communications & development at Lay & Wheeler. www.laywheeler.com

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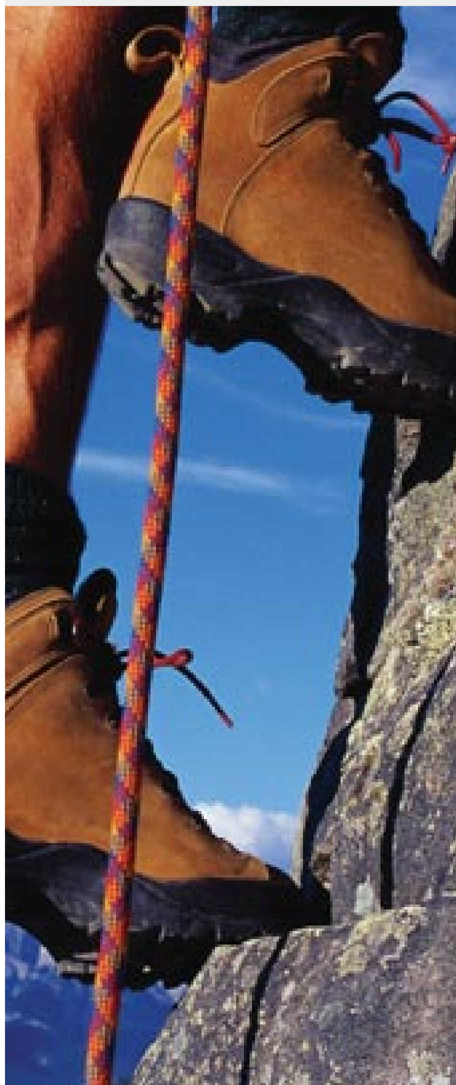

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