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The Independent Financial Advisor

CIFA www.cifafound.ch

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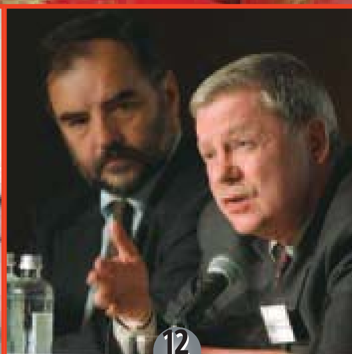

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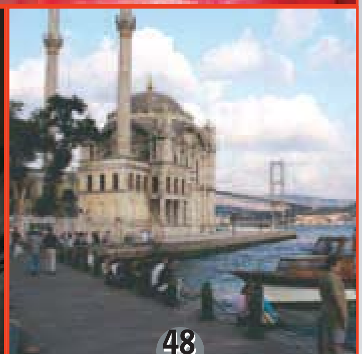

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TRUSTING – The Independent Financial Advisor

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INVESTING – HOW TO NAVIGATE

SPECIAL REPORT

OTHER VOICES

The unabating fight against conflicts of interest

The recent scandals in the fund management industry placed this recurring theme once more in the limelight. Again the eternal question was on all investors-shareholders' lips: what is the main concern of fund companies – their clients' interests or their own profitability?

Despite the heavy penalties on these unscrupulous operators we did not see many of the concerned actors disclose the corporate governance steps (the most recent "darling" of the auditors) they have taken to secure in permanent manner the security of their main raw material – the money that the investors entrust them with.

The big question remains intact: how to secure the highest degree of transparency, especially in times of unprecedented volatility in the securities' markets? At which point will the manager of a fund be tempted to protect his company's interests and pereniality compared to those of the investor?

There again we will fall in to the fashionable debate of internal compliance. Compliance teams often step in after the facts have happened, and in this particular sensitive issue how would the compliance people react? What are the limits of efficiency of such internal controls? Or should such processes be entrusted to independent or external compliance organisms?

One way to address the issue of transparency derives from the recent regulatory settlements in the United States where investment banks had an unacceptable influence on securities research brokerage firms. The result translates into an increasing importance given to truly independent research.

An additional positive step forward allowing a more transparent and efficient decision-making by the investor consists in offering the client free global access to a large number

of products and execution platforms through which trades can be completed.

Most of the important players involved in a very large range of financial services (brokerage, funds, investments, new issues/IPOS) assert that they have set up Chinese walls between the various divisions which may intervene in the process. Others have developed highly technical computer systems that analyse transactions performance in real time.

Both those approaches have their merits but as a London consultant puts it bluntly: "there is more to governance than preventing illegal or unethical conduct. Fund providers need to demonstrate that they know how to run money better than other managers."

Finally this is the most practical and concrete principle to which we can subscribe. These are the simple rules of free competition and open access to markets that would guarantee a safer and less corrupt environment for the investor. But observing the gigantic dimensions that some financial institutions reach nowadays by takeovers or mergers we may question this competitive and open environment that the investor must hope for.

In this same way and in relation to the transparency issue we can note that in most countries the assets deposited by the investors are concentrated in the hands of a few very big players. At which point are these large players ready to offer their clients a neutral and objective choice of a variety of existing products and external asset management firms without being tempted to put forward their in-house products?

Curiously enough it is in the hedge fund industry, which is highly segmented and extremely competitive, that we may find the most challenging environment in terms of investment choice. Taking into consideration the investors' basic concerns: reasonable returns on assets yet with a low volatility.
Is it because this speciality is "less regulated" (the most frequent accusation against the industry) or is it because intrinsically the big players cannot keep the best talents within their organisations? It is an interesting question which deserves a more thorough reflexion.

As a matter of fact and by simple reasoning we may observe that the more open the competitive environment is and the larger the number of participants is, the more the market becomes transparent and prevents possible manipulation and wrong-doing.

Finally there is a fundamental aspect of the independent financial advisor's role, as a U.S. operator describes it, which makes of these practitioners a profession in itself in the financial services world: "The independent advisor does not to have to sell any product. He can truly be impartial." Indeed, and we may add: "this is his main duty."

Pierre Christodoulidis
Executive President of CIFA

Communist France vs. Capitalist France

In 1989, we were in China (a few months before the Tian An Men massacre) on a week-long research trip with other institutional investors. Although clearly on a boondoggle, we left after two days with our minds made up to forego the opportunity to invest in China.

The reason behind our departure was simple: the tension between the various Beijing leaders was so thick, and the contradictions so apparent, that the air itself felt heavy to breathe. In half of the meetings with Chinese officials, we would be given lectures on the great strides of Marxism in China by men in Mao suits; in the other half of the meetings, officials decked out in investment banker suits would elaborate on the great prospects for the Chinese equity markets. Most importantly, the body language between the speakers was such that the fact that they hated each other's guts came across rather blatantly.

Three months later, the Tian An Men massacre cleared the decks. At the time, the Marxists were perceived to have prevailed, but History now shows that a section of the "Free Marketers" then gained control of the Chinese state. Why do we tell this story? Because the situation in France today reminds us of the situation in China in 1989. Like in China, we have in France two systems of production who co-exist in an uneasy cooperation: a capitalist system, and a communist one.

Libération

ILS ONT OSE: LES PAUVRES SONT RICHES...

SMIC : + 10 % Allocations familiales : + 25 %
Vieillesse : + 20 % Handicapés : + 20 %

However, unlike in China, the communist system of production in France is growing at a much faster pace than the capitalist one. Worse yet, the incomprehension between the two systems strikes us to be as wide in France today as in China in 1989.

To quickly summarize the characteristics of a Marxist system, we will use a Marxist grid, looking at how the factors of production (Capital and Labour) are allocated, and then how the external world , the "user", is serviced.

A) Capital in the Marxist Grid

- There is no such thing as a cost of capital.
- Interest rates have no function in such an economy.
- Returns on capital are not considered before making an investment.
- Profits are never a part of the picture.
- Capital is available either through direct access to the government budget or through borrowing, usually through government guarantees.
- There are no bankruptcies.
- Savings have no return.

B) Labour in the Marxist Grid

- Labour is exploitation, and must be avoided.
- Labour is fungible (all workers are equal, i.e. not worth a lot, and can be replaced indiscriminately).
- Life employment is the rule; careers movements are made according to age and/or personal involvement in the unions or the party.
- Unions are heavily subsidized by the government. The work force has no choice but to join the unions.
- There is no such thing as a productivity gain accruing to the users.

Like in China, we have in France two systems of production who co-exist: a capitalist system, and a communist one.

C) Relation Between the Production System & the Outside World

- Prices are not there to clear the market, but are fixed by government or administrative decrees.
- In theory, demand is regulated by administrative means, or by laws.
- In practice, excess demand emerges and we have queues. Otherwise, we have lack of demand, leading to overcapacity and waste.
- Competition is in principle not accepted. As a result, there is no such thing as a "client". A client can move to a different provider, which implies the existence of a competitive environment. A user cannot.

HOW DOES THE ABOVE APPLY TO FRANCE?

If we decide to apply the criteria outlined above to the French economy, we discover pretty quickly that quite a few sectors are operating, partly or totally according to those rules. As we look at it, the French communists sectors are:

- The health system (hospitals, social security, pensions, etc…).
- The educational system.

- The public transportation system.
- General & Local Administrations.
- Energy & Waste Management.
- The postal system.
- The telecom system.

The next step is of course to try to evaluate the relative weight of these sectors in the French GDP. Our methodology will be very simple: the GDP is the sum of the value-added by all the participants in an economy. Through the French national accounts, we have access to the added values of each individual sectors, including the above "communist sectors". If we subtract the value added by these communist sectors from the French GDP, we will have a rough idea of the split between the communist and non communist sectors. Of course, it will be imprecise, but as Keynes said, we would rather be nearly correct than precisely wrong.

The first fact to emerge (see chart 1) is that, since 1978, the French communist economy has grown far more than the capitalist one. On average, the communist sectors have grown by 2.8% per annum while the private sector has grown by 0.8% per annum.

The second fact to emerge from this breakdown is that, since 1978 again, the communist sectors have never had one single recession! Meanwhile, the capitalist sectors had to endure five recessions.

No wonder everyone in France wants to be a civil servant: it pays more, the growth is higher and there are no risks of unemployment. But is this state of affair sustainable? Could we soon be getting to the point that Brezhnev described in 1980 when he said: "they pretend to work, and we pretend to pay them?"

One worrying fact that emerges clearly from the above chart is that the communist sectors are on the verge of their first recession while the private sector is close to plumbing new depths. So what happens next? To look ahead, maybe we need to first look back.

WHAT HAPPENS NEXT?

Since 1945, France has been under an unspoken sharing of power: the Right and the Socialists would fight for political power. Meanwhile, control of the communist economy would be vested in the hands of the unions (CGT, CGT-FO or CFLT). These communists (CGT) and Trotskyites unions (CGT-FO) more or less control all the sectors we have identified above as the communist sectors.

The impressive growth of the communist system we also reviewed above was only made possible by a constant transfer from the non communist to the communist economy through ever increasing subsidies (taxation) and debt. In turn, these transfers led to a structurally declining growth rate of the whole of the French economy, and to a solid accumulation of debt (French government debt is now a solid 60% of GDP).

However, one day, the French economy will start falling in absolute terms, simply because the private sector will no longer be able to finance the communist economy. The above chart leads us to believe that this day might be approaching fast!

THE COMING POLITICAL CRISIS

And that day, France will confront a massive political crisis; the government willingly or unwillingly, will have to go for the clash, as Mrs. Thatcher did with the miners, or President Reagan did with the air-traffic controllers. Last spring, we experienced a few skirmishes when PM Raffarin presented his pension plan reforms. We believe that these were mearly the opening salvos of a "war" which could end up being very long and very bloody for all participants.

Undeniably, the real fight has not even started. But we nevertheless know quite a few things:

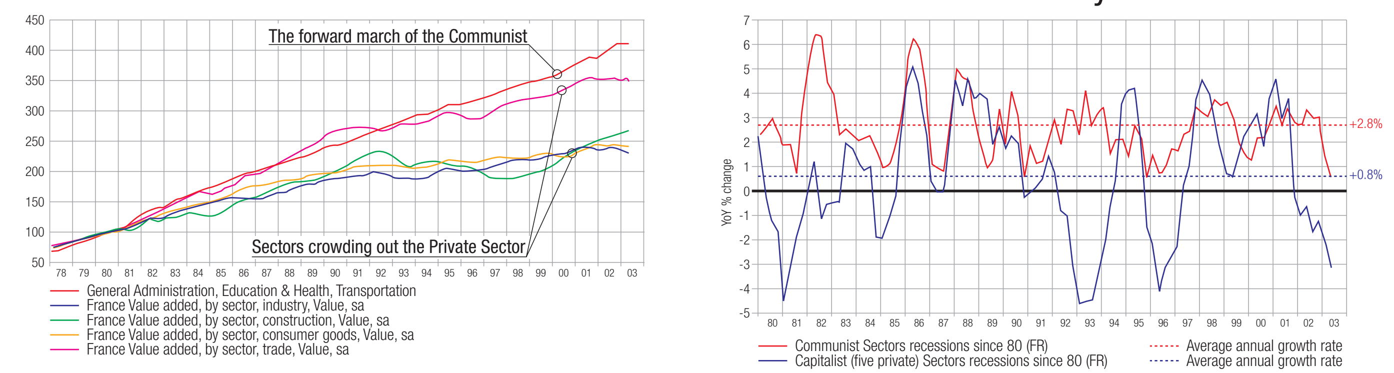
1. Present trends are unsustainable
2. They will end with a major political clash.
3. While we are certain that the clash will happen, we are not convinced about our timing (very modestly, we will point out that Von-Mises and Hayek explained very convincingly that the Soviet Union could not work and that it would therefore collapse in the 1920s & 1930s….).
4. There is no certainty that the fight will be won by the "free economy" (i.e.: Argentina, Venezuela…).
5. The trends that we have highlighted in this paper have not gone unnoticed in the French capitalist sectors. Our work with French companies re-enforces our belief that a number of small French companies have already delocalized and that a number of big companies are also considering a move (see Voting With Their Feet).
6. For the first time ever, more than one million French citizens are living abroad. The countries where Frenchmen have moved to in hordes (US, UK, Switzerland, Asia…) are indicative of what they are looking for. The new entrepreneurs are moving to the Anglo-Saxon world, to be able to create. The old entrepreneurs who have been successful, are moving to Switzerland, to avoid the punitive French tax rates.

CONCLUSION

France, like a number of European countries, is teetering on the brink of a political crisis. With the Tien An Men massacre, we learnt that it was a lot safer to invest after a simmering political problem had erupted to the surface than before. With this in mind, we reiterate our underweight recommendation on European equities and currencies. We are especially worried about all things French.

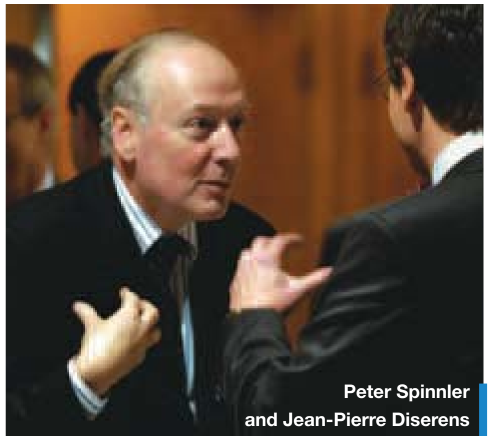
Charles Gave
GaveKal Research Limited
www.gavekal.com

Communist & non Communist Parts of the French Economy



Europe's leading IFAs in Geneva

After the success of its first international congress in April 2003, the Convention of Independent Financial Advisors held its 2nd International Forum on 22-23 April 2004 in Geneva. The participation of five European federations and 24 national associations (vs. respectively two and eight in 2003) confirmed the growing importance of this event for the international IFA community and its business partners.



Peter Spinnler and Jean-Pierre Diserens

Angela Knight, Pierre Christodoulidis, Jean-Pierre Diserens and Richard Smouha

In his opening speech, Richard Smouha, CIFA Forum Chairman, stressed the important role played by the independent financial advisor as a reassuring human link between the consumer-investor and the large banks and financial companies.

Jean-Pierre Diserens, Founding Member of CIFA, stated that CIFA defends the rights of the consumer to invest freely wherever he wishes, to protect himself against expropriation, and to benefit from an absolute protection of his privacy. If co-regulation in the consumer's interest is indispensable for the harmonious and effective growth of the financial markets, self-regulation among independent financial advisors is the sole alternative which can guarantee the consumer a tailor-made quality service at a reasonable cost, Diserens added.

WHERE DOES THE PROFESSION STAND?

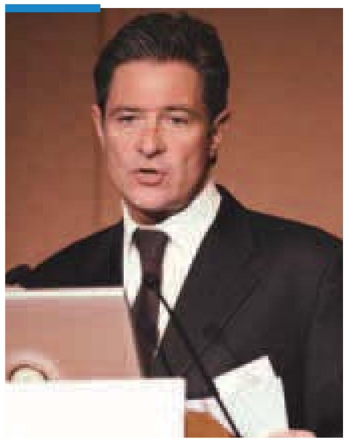
Under the suggestive title of "Reinventing Trust", CIFA's second Forum began with four round tables on themes that are of major interest to the profession: taxation of savings in Europe, protection of privacy, regulation of the profession in Europe and the means to restore the investor's confidence.

SELECTED STATEMENTS HEARD THAT DAY:

"(...) it is my belief that the strategies that impact consumers across Europe have not yet been thought out by the policy makers. Governments have not followed up their policy desire to get individuals to save with the coherent tax reliefs that will encourage them to do so. (...) EU policy makers are seeking to get everyone to do things 'the same way' rather than recognising equivalence, and changes have been set in motion which are unlikely to bring little beneficial early impact on the consumer. Meanwhile the professional advisor has big opportunities, provided they can cater for the changing regulatory environment on the one hand and on the other, the increasing demands of the new clients and potential clients that welfare changes and increasing life expectancy are bringing."
Angela Knight, Chief Executive, Association of Private Client Investment Managers and Stockbrokers (APCIMS), London

Carlo Lamprecht

Daniel Penseyres



Hansjörg Pack

Pierre Mirabaud

Josep Soler, Xavier Raufer and Michel Tison

"Today, our professional activities (advice and mediation) are penalised by extremely constraining regulations, the soaring cost of compliance procedures, the development of unreliable new technologies, and the demands of a generally distressed and ill-informed clientele."
Vincent J. Derudder, General Secretary, European Federation of Financial Advisers and Financial Intermediaries (FECIF)

"I observe that the respect of privacy and the protection of personal data are values which, far from being old-fashioned, are on the contrary gaining importance in the mind of the public."
Pierre Mirabaud, Partner, Mirabaud & Cie; Chairman, Swiss Bankers Association

"(...) Are the small players going to continue to find their savings threatened by the manipulations of unscrupulous dealers? No. Better coordination between corporate bodies anxious to preserve the reputation of their profession with the monitoring authorities, backed by the judicial authorities, could lead to a long-term effective reduction in such crimes. No purely repressive system has ever succeeded with active coopreation between all interested parties, namely the professionals, the monitoring authorities and the judicial system."
Pierre Christodoulidis, Executive President of CIFA

"(...) Regulation: since the early nineties, en ever increasing avalanche of rules, which increased both in volume and intensity during the last years, (...) has lead to costs – directly and indirectly related to supervision – to rise more by than 22-fold since 1996!"
Wilfred Aalders, Deputy Chairman, Dutch Association of Assets Managers

WORKSHOPS AND PRESENTATIONS

The second day began with workshops on the respective themes of regulation, education, investment techniques and the selection of investment funds. Later on, the Forum participants learned all about the intricacies of hedge funds, before discovering an innovative concept for the transfer of funds, and participating in the final debate.

René W. Rohner
Secretary General of CIFA

The views shared by participants lead to the following declaration of intent, made at the end of the Forum:

Declaration of intent made by the participants of the CIFA Forum 2004

CIFA is pledged to the establishement of an orderly, transparent and efficient European market of financial services that the consumer may approach with confidence.

CIFA therefore would like to invite representative bodies of relevant financial associations to join in an umbrella organisation that presents the reasonable expectations of the consumer and the objectives of the retail investment industry, in a manner that is productive and equable to both parties.

To this aim CIFA has enlisted the support and assistance of its over 30 partner federations and associations operating throughout Europe, and looks forward to discussions with further representative bodies of similar professional interest groups.

16 & 17 March 2005, Geneva, Hotel Noga Hilton

Let's provoke a dialogue

Keynote speaker: Marc Faber, **Editor and Publisher of "The Gloom, Boom & Doom Report", Hong Kong, and author of the bestselling "Tomorrow's Gold"**

Wednesday 16th March 2005

8.30 Registration

9.00 Conference Chairman's welcome address

9.05 Messages from the Swiss Federal and Cantonal authorities

9.25 **Talking to the regulators: why ? what for ? for which objectives?**

Jean-Pierre Diserens, Founding Member of the CIFA

9.30 **Regulation: which objectives?**

- Is the real purpose of regulation not more the fight against tax evasion than economic crime?
- Does regulation play a positive role for consumers when it increases the administrative costs of financial intermediaries and restricts competition?

Angela Knight, Chief Executive, Association of Private Client Investment Managers and Stockbrokers (APCIMS), London
Paul Rich, Sector Manager, Retail Intermediaries, Financial Services Authority (FSA), London
Jean-Baptiste Zufferey, Professor, University of Fribourg, Deputy Chairman of the Federal Banking Commission (CFB), Member of the Consultative Committee of the CIFA
Additional panelists subject to confirmation

11.00 Coffee break

11.30 **Corporate governance: an efficient set of rules to win back consumer's trust?**

- Corporate governance: just more controls or more sincerity and transparency?
- Corporate governance for financial intermediaries: what should be done to rebuild consumers' trust?

William Witherell, Director for Financial and Enterprise Affairs, OECD, Paris
Additional panelists subject to confirmation

1230 Lunch

14.00 **Adjusting regulation to the financial intermediaries' activities**

- National, European and international regulators: how to harmonise the rules and avoid the jungle of legal procedures?
- External regulation and internal compliance rules: complementarity or additional administrative burden? Is there an end to the constant proliferation and hardening of rules?
- Case study: the Investment Services Directive II: the professional associations speak to the European Commission

Moderator: Michel Tison, Professor, Financial Law Institute, University of Ghent
Speakers:
Dr. Günter Birnbaum, Executive Director, Securities Supervision, Federal Financial Supervisory Authority (BAFIN), Bonn
Pierre Bollon, Director General, Association Française de Gestion Financière (AFG), Paris
Alexander Pohle, President, AfW-Arbeitgeberverband der finanzdienstleistenden Wirtschaft e.V., Berlin
Hubert Reynier, Managing Director, Regulation Policy and International Affairs Division, AMF The French Securities Regulator, Paris
Additional panelists subject to confirmation

15.30 Coffee break

3rd International Forum of the Convention of Independent Financial Advisors

CIFA

with the regulators

Provisional programme

Thursday 17th March 2005

16.00	**Building a real self-regulation** - Reinforcing self-regulation or let "bureaucrats" impose inefficient and unrealistic rules? - Self-regulation: comparative advantages and key criteria of success **Moderators:** **Pierre Christodoulidis,** President of the CIFA **Vincent J. Derudder,** General Secretary, European Federation of Financial Advisers and Financial Intermediaries (FECIF), Brussels **Speakers:** **Claude-Alain Margelisch,** Deputy CEO, Swiss Bankers Association, Basel **Richard Stevens,** Member of the Board, Cyprus International Financial Services Association (CIFSA), Nicosia *Additional panelists subject to confirmation*
17.30	End of the first day
20.00	Networking dinner

Updated programme and registration form on
www.cifafound.ch

8.30	Registration
	Four financial centres in the limelight - What are the advantages offered for private banking, tax planning, investment funds, hedge funds, life-insurance and trusts? - How efficiently is privacy protected? - How will the European Savings Taxation be implemented? - Will financial intermediaries' regulation evolve in a more favorable way? - What is the importance of due diligence obligations? - What is the level of self-regulation? **9.00 - 10.30**
A1	**SINGAPORE** **Host:** SG Private Banking **Speaker:** Monetary Authority of Singapore
A2	**LUXEMBOURG** **Speaker: Robert Hoffmann,** Director General, Association of Luxembourg Investment Funds **11.00 - 12.30**
B1	**UNITED KINGDOM**
B2	**SWITZERLAND**
12.30	Lunch
	Plenary session
14.00	**We are never prepared for what we expect** **Keynote speaker: Marc Faber**
15.00	Conclusion by the President of the CIFA
15.15	End of the 3rd Annual Forum of the CIFA

Exchange Traded Funds: Deliver us from temptation

Portfolio diversification is expected to be a piece of cake for exchange traded funds (ETFs). But are they really invincible in terms of cost? Diversification is essentially ensuring not to put all your eggs in one basket. But has anyone paused to consider the dangers of having too many baskets?

Upon entering the European market, ETFs were expected to sound the trumpet for more traditional index funds due to their highly competitive management fees. Yet, traditional index funds are still flying high and even more have been created since then. Why? State Street Global Advisors (SsgA), a department of the State Street group focused on asset management, is the organisation most apt to answer this question. First runner up on the ETF market with a 27.33% share and 65.6 billion dollars under management [1], SsgA was the first to launch an ETF on the S&P 500 in 1993. This fund, the SPDR or Spider, represents some 26 billion dollars . The asset management company has two product lines in Europe: ETFS that are collectively known under "streetTRACKS" label, and traditional index funds under the "Balzac" label. The latter currently represent a volume three to four times greater than the ETFs' 1 billion. Head of index fund management at State Street's head office in France, Frédéric Jamet notes that ETFs have sustained steadier growth than those under the Balzac label. He surmises that this is due primarily to the infancy of streetTRACK funds relative to those of Balzac that represent a "more mature" industry. However, Jamet has not ruled out the hypothesis that this growth may be a result of the lack of direction among today's markets – a phenomenon that can provoke activism.

COMMISSIONS ARE TO BE NEGOTIATED

As to whether or not these two types of funds are actually competitors, Frédéric Jamet thinks otherwise: "Technically speaking, they are almost the same but each of them addresses very specific needs. Large institutions that have a long term investment horizon tend to buy funds, while investors that focus on trading , particularly hedge funds, prefer ETFs." Contrary to popular belief, and as long as the investor is in a position to negotiate commissions, traditional funds are not significantly more onerous than ETFs. In the case of State Street, the gap in management fees is around 10 basis points. In general, concludes Jamet, this gap basically depends on the promoters' business policies.

NEED SOME HELP?

What then are the advantages and disadvantages of each in relation to the other? The ETFs have the advantages of speed and simplicity. They do not require extensive relations with banks and allow for anonymity (an important factor for hedge fund managers who are by no means eager to share their management strategies with others). On the other hand, ETFs demand some degree of professionalism of the investor. Stock listings offer a great deal of flexibility and also provides the possibility of using short-selling. However, order execution poses some risk. ETFs are negotiated with a spread to their Net Asset Value (NAV). It is therefore incumbent upon the investor to ensure that the execution of his orders are conducted at a fair price as it is upon this price, which cannot be determined beforehand, that the final cost of the ETFs lies (2). Traditional index funds do not pose such risks as purchases and sales are conducted according to the NAV. In addition, the fact that they originate from a promoter guarantees the investor some level of advice, information, and reporting which are virtually absent in the case of ETFs. And if any cost gap should appear between the two types of funds, it basically represents the cost of these "decision-making aids". Such were the arguments presented by Jamet. However, a number of specialists interviewed about the Swiss market do not share his opinion. According to them, ETFs offer a clear advantage in terms of management fees. On these grounds, some recommend ETFs for institutional investors with long-term horizons as well as for assuming core positions in global portfolios. To demonstrate the merit of this point of view, they offer the example of an ETF on the S&P whose annual management fee is 10 BP while that of a superior index fund ranges from 40 to 50 BP. Obviously, in the long run, this divide proves to be far from insignificant.

POPULARITY IS A GOOD SIGN

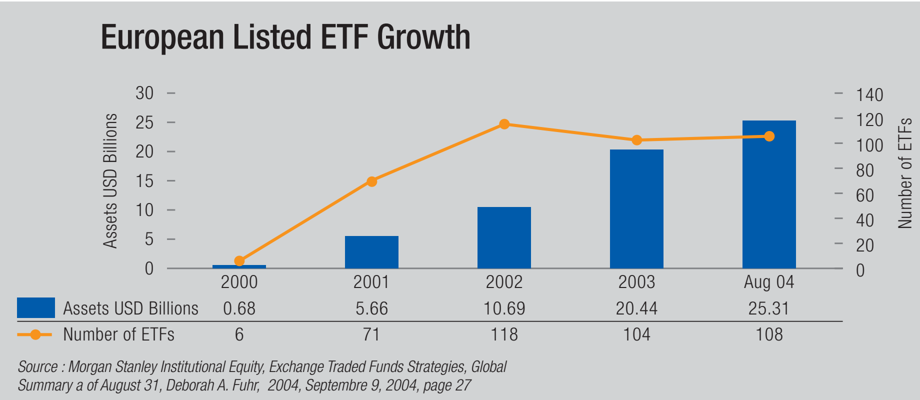
To these "visible" costs may be added others that complicate comparisons and, consequently, the search for alternatives. Last May, State Street announced the closing of streetTracks MSCI UK ETF due to a "lack of volume". According to Frédéric Jamet, the choice of an index plays a crucial role: for investors on the British market, it would indeed seem that the FT 100 index is a lot more popular than the equivalent MSCI. In the event that an ETF is closed, reimbursement is conducted in cash or, if the amount invested is sufficient, in stocks of the underlying portfolio.
From the perspective of the investor, in both cases, this presumes reinvestment and thus, additional costs. Keeping in mind that the European ETF market is generally considered to be too segmented, and that the industry is still in its infancy, closures are more frequent than on the more mature market of traditional funds.

A SOLUTION TO RISK-BUDGETING?

Outside of their weak cost, ETFs are generally presented as the panacea of diversification. In its brochure devoted to trackers, Euronext writes: "Investing is making choices. Yet, on the Stock market, the right choice is often diversification, a solution that can prove costly in terms of time, arbitrage , analysis, and immobilised assets . Trackers enable fast, simple, and economical investment in a diversified stock portfolio that is representative of an industry or market." More specifically, Pictet notes: "The current highly competitive asset management environment is characterised by growing interest in investment solutions that reconcile increasing revenue pressure with the proliferation of risk control measures. With a view to improving the efficiency of asset allocation, investors are looking for an appropriate balance between high-alpha (satellites) and index (core) products. Depending on the active manager risk budget that investors want to allocate to a portfolio at a given time, this approach fits in the need to make asset allocation shifts on a regular basis. Including index funds in a wrap investment vehicle is a mean of fine-tuning the risk trade-off between alpha-generating investments (carrying high stock-specific and relative risk) and the portion of the portfolio tracking the market (market risk only)."

NOTHING BEATS AN ORIGINAL

Whether it be via ETFs or traditional funds, passive investing is recommended as an "efficient" solution to diversification.
In theory, certainly. In practice, however, passive investing is not without some drawbacks. There are several types of indexing



(see graph 1) and replicating the performance of an index does not necessarily mean to grasp all its constituents. ETFs favour flawless replication but, as BCV's Frank Hirschi adds: occasionally, one is unable to use pure replication because of too low volumes, the underlying markets' inadequate liquidity, or legal limitations (for example, according to Luxemburger law, a security may not surpass 10 % of the total NAVof the fund). In a scenario such as this, replication by "sampling" is used. However, this method poses the drawback of slightly increasing the tracking error" [3]), which, in turn, has a destabilizing effect on asset allocation.

TRACK THE ERROR!

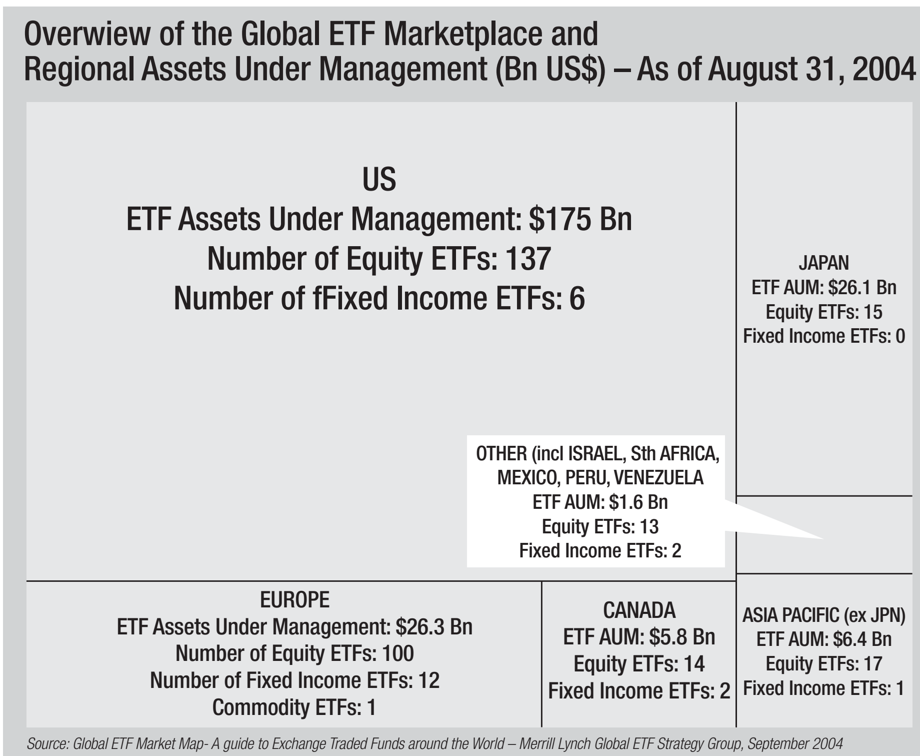
Launched by Pictet last March, the index fund PF-Emerging Market Index offers an example, which, though extreme, demontsrates what happens in low-liquidity markets. This index fund comprises 400 stocks selected to represent the index as faithfully as possible by means of a replication method developed internally. With 400 stocks, the fund recreates an MSCI Emerging Market Index that has over 600 constituents. As Pictet Marketing Manager Stephen Brülisauer explains: "one must strike a balance between as firm a grasp as possible on the index and the costs that this might entail." This concept is further explained in the fund's brochure: "Investing in emerging markets is clearly more complex than engaging traditional markets. Indeed, one must take the specific demands of local markets, and investment regulations and procedures into consideration. Hence, it proves more advantageous to avoid onerous transactions and maintain a high tracking error. The expected tracking error will stand between 3% and 5% while that of traditional index funds is less than 1%." Can an ETF do any better? It is hardly likely since the most diversified funds in that sector seem to have only 250 stocks.

THE SMI: COMPLETELY OFF BALANCE

The above demonstrates that the copy or replication of indexes is not always ideal due to both the cost and legal factors involved. In an effort to diversify one's portfolio, selecting just about any ETF based on cost considerations simply will not do. In selecting a fund, one must take into account both the quality of replication methods as well as the legal constraints that are applicable to these vehicles. More importantly, one must address the question of whether or not an index is necessarily diversified. Investopedia proposes a basic definition of diversification: "A risk management technique that mixes a wide variety of investments within a portfolio. It is designed to minimize the impact of any one security on overall portfolio performance". Yet, indexes are not only created to minimize the impact of one stock in their particular universe. The Swiss Market Index illustrates this marvellously: its five dominant positions represent almost 75% of the index. On its own, Novartis make up 21.73% of the SMI. From an sector standpoint, these five stocks represent three industries - pharmaceuticals, finance, and foods. No "traditionally" diversified fund would be as densely concentrated per stock or sector!

INDEX SEEKS PARTNER

As we saw earlier, ETFs are particularly well adapted to markets with the highest liquidity and those which enjoy the highest volumes. Thus, on the Swiss stock market, there are several ETFs on the SMI but none on the SPI. The only index fund listed on this index is a traditional index fund, Synchrony Market Fund Swiss Equity. One can therefore assume that ETFs will present a bias towards big caps . In and of itself this is not problematic. However, from a diversification point of view, it calls for the precise definition of the scope of the underlying index of the ETF and measures necessary to find its complement on the market.



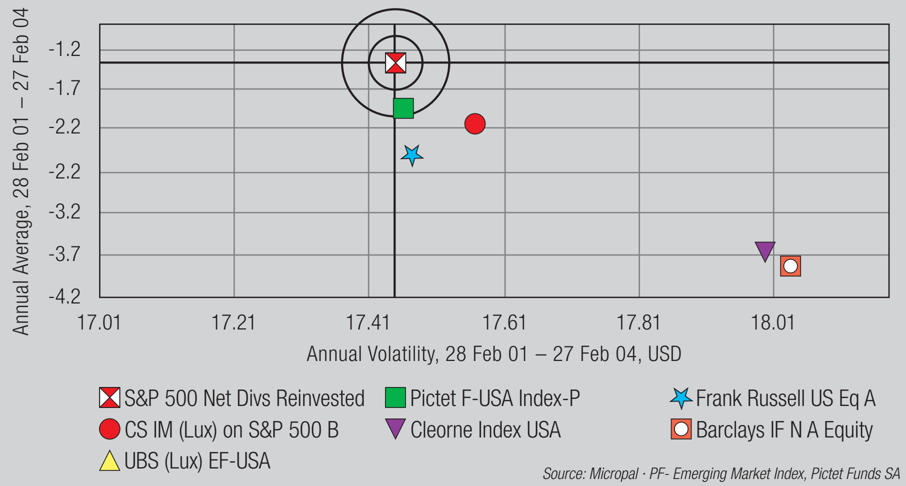
To choose the Dow Jones Euro Stoxx 50 is to opt for a a blue-chip representation of market sector leaders in the Eurozone, that is to say, for 63% of the Dow Jones Euro Stoxx which in turn covers approximately 95% of the free-float market capitalization of the represented countries. If one means to cover all or a part of the 37% remaining on the European market, which complement will be most adapted to the Dow Jones Euro Stoxx 50? How can an investor who has already invested on the Swiss market will be able to cope with the fact that the DJ Euro Stoxx 50 includes stocks such as Novartis, Nestle, UBS, Roche and CS whose weightings are not to be overlooked? Finding solutions among the wider array of ETFs that exist is no easy task.

NEITHER SIMPLE NOR STABLE

As these indexes are not all equal, the investor must then select those that are most advantageous to his strategy. Yet, all is not black and white in the world of the index fund. One need only apply any one of the myriad of index calculation methods currently in existence: the Dow Jones Stoxx guide offers some thirty pages, some of which provide complex mathematical formulas beyond the grasp of mere mortals, and probably even that of seasoned investors. One can also compare the indexes covering seemingly similar areas. Detecting the biases that might result from their respective designs is not a process of elementary mathematics.

Finally, indexes are by no means stable. In a research report judiciously entitled “Comparing Apples” [4], the author analyses the impact of Dow Jones index revisions. He writes, “The Select Sector Indexes were heavily revised June 24, 2002, substantially altering the makeup of several of them […] Some have been so heavily revised as to raise the question of whether their performance post-revision can legitimately be compared to performance pre-revision.” This type of revision or modification of calculation methods is far from exceptional and it adds performance deviations that are completely independent of the markets’ evolution.

Risk/Return Profile: the PF – USA Index Fund (net costs)



Source: Micropal · PF- Emerging Market Index, Pictet Funds SA

WHAT CONSTITUTES PERFORMANCE?

The last pernicious characteristic of these “light” vehicles known as ETFs is that this very “lightness” of character reduces the importance of one of the most difficult decisions in asset management, namely asset allocation. I buy Turkey for breakfast and sell it by snack time - that is the tempting game that results from these tools - running the risk of losing sight of the structure of one's portfolio, gambling unthinkingly in sector or capitalisation-based risks. Nowhere in the literature proposed by ETF promoters is there the slightest mention of correlations analysis or reflection on the potential risk of portfolio dispersion. This is even more surprising in light of the fact that there is currently much upheaval in the arena of modern portfolio theory, not to mention increasing doubt about the sense behind diversification as it has been conducted thus far. Should one really strive for geographic diversification or, on the contrary, apply a sector-based approach on a global scale? What is optimal diversification? Does one not tend to dilute performance by over-diversification? These are questions that are far from being answered and yet crucial as, in the final analysis, almost 80% of portfolio performance relies on the sensible allocation of assets.

Véronique Bühlmann

Differences between ETFs and other funds/financial products

Characteristics	ETF	Index Funds	Index forecasts	Index certificates
Pricing	continuous	Daily NAV	continuous	continuous
Liquidity	strong	No stock market negotiation	strong	average
Maturity	None	None	Limited life	Limited life
Short-selling	Yes	No	Yes	No
Purchase/ sale cost	Spread + brokerage costs	Issue/Redemption commission	Initial + variation margin payments + rollover costs	Issue/Redemption commission
Management fees (TER)	0.3 – 0.7% (CH) 0.1-0.3% (USA)	0.4-1.2%	No	Approx. 0.5%
Dividend payments	Generally twice a year	Generally annual	No	No

Source: BCV (les ETF de A à Z cf. note 3)

[1] Figures cited from the Morgan Stanley Report – Global Summary as of August 31, 2004. According to this report,Barclays Global Investors (BGI) is the largest ETF manager globally with assets of US$ 94.2 billion or 39.25% market share. In terms of number of products, BGI is ranked first with 121 products - more than three times that of SsgA.

[2] A maximum spread is defined by the stock exchange regulatory authorities. It is a maximum of +/-1% on the SWX and +/-1.5% on Euronext. But as Frank Hirschi notes about the BCV (see note 3): “ETFs being a relatively recent development, no one knows if the market markers will be able to bear the ETFs’ trading in the event of a huge stock market crash.”

[3] *Les ETF de A à Z, Les Cahiers de la Finance*, Frank Hirschi, Banque Cantonale Vaudoise, September 2003 (20 pages). E-mail: research@bcv.ch

[4] “Comparing Apples: Sector indexes are not all the same”, Research Report by Harry Seneker, Dow Jones Indexes, November 2003.

Hedge Funds: Reinventing the industry

Can the current pace of new product creation last? That's the pressing question on the lips of investors...and some of the most eminent specialists such as Tanya Beder, Tribeca Investments CEO, not only see it lasting, but *speeding up*!

"Learn and adjust" – that is essentially what 1997 Nobel Economics prize winner and LTCM partner Myron Scholes stated at the BSI Gamma Foundation conference on Hedge Funds[1]. His speech on "Risk Management in a chaotic environment", came to the conclusion that we have a dictionary (of risks), but that is not enough to master the language. In other words, corporations and investment managers do not use the tools of risk management efficiently.

The incorporation of risk management tools into management is a growth area that will change investment management and corporate activities. Competition will create the need for them to incorporate risk management tools in everyday management.

BARELY OUT OF THE HIGH CHAIR

Returning to and broadening her commentary on this issue, Tribeca Investments CEO, Tanya Styblo Beder[2], sought to describe "The changing face of hedge funds", hedge funds which are certainly among the largest users of risk management tools. While critics seem increasingly acerbic, deplore the decline in hedge fund performance, question their efficiency in terms of diversification, and wonder whether or not alternative management can yield high returns in periods of trendless markets, Beder placed these troubling issues within the framework of the fundamentals of an industry which, like all industries, experiences periods of reorganisation and significant development resulting from innovation.

According to Tanya Styblo Beder, compared to an industry that dates back thousands of years such as transportation, hedge funds is virtually infantile having only begun in 1940. But like in transportation, it has undergone monumental technological advances, particularly in telecommunications and data processing, and also major deregulation. It is on these bases that one could develop new tools and quantitative management methods.

HALF EMPTY OR HALF FULL

As in the transportation industry, "inventions are driven by those who discover and pursue the frontiers of knowledge" states Beder. However, she goes on to add that "it can be a rough ride." Indeed, "new discoveries require larger investment and may not yield great gains and knowledge dissipation and competition drive early profits down to modest gains, maybe losses." Therefore, in the world of hedge funds, one can consider the glass to be either half full or half empty. The pessimist is likely to say that there are too many entities using similar strategies and that, consequently, one should expect meagre returns and a permanent reduction in alphas. But, to the optimist, the fact that many are using similar strategies can only lead to new types of arbitrage and, therefore, very high returns on the very outskirts of overcrowded strategies. And if historical trends no longer hold, new ones are emerging. In other words, alternative investment resumes its basic form: investment off the beaten track.

DATA WITH EXPONENTIAL GROWTH

Why should one side with the optimist? From an industrial point of view, argues Beder, the hedge funds sector is in its infancy. Relatively little time has elapsed between the first computer, the ENIAC that filled several rooms, and our modern computers. Yet, their capacity for calculation and data storage has grown exponentially. Each year, we double the amount of data collected. This process of constant evolution has enabled our investors today to get 80% of their information for 1% of the former cost. Communication lines continue to improve: whereas it was once at 1 terabit per second in 1996, in 2001 it leaped to 100 terabits per second and continues to evolve quite quickly. Executing orders is now done almost entirely by electronic means and over 80% of the world 's exchanges are electronic.

UNCHARTED TERRITORY EXISTS YET

The hedge fund industry was among the first to take advantage of this infrastructural evolution, but it still remains extremely fragmented. Currently, hedge funds make up 15,000 employees. The average hedge fund amounts to less than $100 million and lasts less than 5 years. In comparison, in more "traditional" management funds, the top 100 managers run18 times the assets of HF with 9,500 personnel. They also last much longer. These findings led Tanya Beder to conclude that a host of new opportunities awaits exploration. She stresses all the unexplored possibilities created by new technologies, particularly in systematic trading, high frequency trading, and new data mining. In this area, big players have the advantage of size which enables them to harness highly powerful computing and date processing systems. Beder also sees new possibilities in credit arbitrage and catastrophe strategies. Lastly, she finds that some areas have not been fully explored, particularly fundamental global macro and value-driven strategies.

INSTITUTIONALIZE IT!

Structural change (in asset management) "is driven by the very success of the hedge fund business," argues Styblo Beder. Formally too small to attract major financial institutions, its size is no longer a hindrance as the demand among institutional investors has become too significant to ignore. Drawing from the DB Survey of 323 institutions with more than $380 billion in hedge fund assets, the Tribeca Investments CEO notes indeed that in all the "traditional" hedge fund strategies, institutional investors plan to increase their allocations. She foresees hedge fund assets leaping from $700 billion dollars in 2004 to $2 trillion by 2010.

Styblo Beder finds that, in this pattern of growth, large financial institutions enjoy a structural advantage provided they manage to overcome a certain number of obstacles:

- identify and put new talent to work quickly
- create the right infrastructure under talented traders
- provide economies of scale for costly – but necessary – technology platforms
- solve HF survivorship challenges
- solve capacity issues inherent to current HF industry

IN SEARCH OF INEFFICIENCY

Regardless of their size, all the hedge fund industry players are more than aware of the need to overhaul the industry. As Dr. Phillip Cottier, "At Harcourt, we do think that Q2 was unusual in that not one single market event but rather many simultaneous, coincident events led to the drawdown… We also think that going forward, top-down strategy allocation will become even more important than in the past… Fortunately, new strategies are appearing on the fringes of today's hedge fund industry… On its constant strive for returns and search for the next pocket of inefficiencies, the hedge fund industry will move into these new, uncorrelated areas. With accelerating inflows from investors, the need for the hedge funds to constantly reinvent themselves will increase." [3]

Véronique Bühlmann

[1] Hedge Funds : Theories and Practices, Conference BSI GAMMA FOUNDATION, 16 September 2004, Lugano

[2] Tanya Styblo Beder joined Citigroup Alternative Investments in May 2004 as Managing Director and CEO of their single manager proprietary hedge fund unit, Tribeca Investments LLC. Previous to her move to Citigroup, she was a Managing Director and Head of the Strategic Quantitative Investment Division of Caxton Associates, LLC.

[3] swissHEDGE, 3rd Quarter 2004, Quarterly Review, Dr. Philipp Cottier, "Reinventing the hedge fund industry" page 7.

Investment funds For better or for worse

Flooded with investment tools, the private asset manager has to stand his ground for his very freedom. Bonds, shares, ETFs, guaranteed capital products, and hedge funds: for each of these assets, it boils down to one thing – a "fund" amental question.

Independeant asset manager and president of Investissima, Jean-Michel Genin has gained a wealth of experience in asset management, working for large Swiss and foreign corporations as well as a small private bank in Lausanne.

INTERVIEW

TRUSTING: Is there no getting away from investment funds?
J.-M. Genin: Why try to get away from them? Funds are as much a part of the investment world as shares, bonds, structured products, ETFs and so on. But I think one must avoid taking extreme positions that entail managing assets only by way of funds. To do that is essentially giving up in the sense that performance is wholly "delegated." Personally, I will seek out funds that have outdone my own performance in the past and provide adequate diversification opportunities. This argument is very important. Take a fund on the Swiss stock market – with Nestle, Roche, Novartis, and UBS making up more than half of the index, I don't see how it is diversified.

TRUSTING: That case is rather beyond the norm. The question ought to be: does direct management enable one to achieve sound diversification?
J-M Genin: The first obstacle lies in the volume under management. With anything less than 300,000 francs, I fail to see how to attempt diversified management without funds. Beyond that, it all depends on the clientele's demand. What is certain, however, is that I don't see the point of funds on markets in which one already has a stronghold. For example, I don't see why one would still turn to Swiss franc bond funds today, with returns that average between 1.5 and 1.8% per annum and Total Expense Ratios of around 1.3%. It's all in the figures: at the end of the day, the investor will be left with nothing at all.

TRUSTING: Aside from the cost issue, do you think that one can invest directly in bonds and still stay sufficently diversified??
J-M Genin: Yes. Funds are only worthwhile in one instance – when one seeks to make one's performance more dynamic, such as by entering the high-yield bond market. However, in the AAA bonds, regardless of the interest rates level, it is a waste of time to use funds.

TRUSTING: Even on foreign markets, such as the United States'?
J-M Genin: Yes. And if one isn't necessarily familiar with all the American borrowers, there are enough European companies that conduct loans in dollars. For a portfolio, five to six AAA bonds are more than adequate.

TRUSTING: And that would constitute a diversified portfolio?
J-M Genin: Certainly. Statistics show that in the AAA investment grade universe, the risk of bankruptcy is 0.001%, that is virtually nil. Furthermore, between AAA and bankruptcy, there is often a decline in rating which acts as a buffer, thus limiting the credit risk.

TRUSTING: If you buy a bond in dollars and you're supposed to hedge the exchange risk, what do you do?
J-M Genin: You have the same problem with a fund denominated in US dollars. The only fund that may prove promising would be a fund that is diversified across the totality of the bond market and hedges its exchange risks against its reference currency. In theory, it is possible to make its own hedging, but, in my opinion, the asset manager who believes himself capable of this feat has never done so in the first place. Hedging takes money. We tend to hedge for a given time-frame: six months, or a perhaps a year, and then, tired of paying for no reason, we stop doing so – just when hedging would have been necessary!

TRUSTING: Going back to stocks, let's take the Swiss small caps . How would you handle that market?
J-M Genin: I would rush back to funds and would seek a Swiss equity product ex-SMI. In this specific case, there is also the volume factor to consider. On the Swiss stock exchange, some days, significant increases occur on the exchange of a mere 25 or even 10 stock certificates. With such low volumes, it is best to opt for a specialized fund. Furthermore, the small caps pose a higher degree of risk than blue chips. Consequently, the diversification of the portfolio will have to assume a wider scope. One would have to keep a minimum of 15 companies. For an individual portfolio, this would lead to far too insignificant positions.

TRUSTING: Because the array of funds available is immense, does one not tend to over-diversify portfolios?
J-M Genin: When I hear some people say that their portfolios are adequately diversified because they placed their assets in three dif-

ferent banks – UBS, CS, and BCV – I am indeed doubtful. If I examine their portfolios, the funds of the various promoters are virtually identical. In a case like that, one's portfolio would actually be under-diversified.

For diversification purposes, some recommend fund of funds. Perhaps it's a solution, but as long as it doesn't turn out to be "a fees of fees" construction.! Obviously, if I have a hedge fund that yields 8 – 10% per annum, the cost issue becomes minor at best.

TRUSTING: Back to the over-diversification issue.
J-M Genin: It boils down to cost. When one goes solely down the investment funds'path, this comes with a price. If in the final analysis, one achieves one's objectives, the cost of funds are of no concern to me.

TRUSTING: The Unites States represents approximately half of the world's stock market capitalisation. Should one work this market directly or through funds?
J-M Genin: One can deal directly. When you decide to enter a sector, such as the high-tech industry for example, you can select a fund that comprises all the big names of that sector – Intel, Apple Hewlett, and so on. Or, as I have, after all it is my profession, you choose two or three among them that are sufficiently visible. Of course, in this instance, I don't diversify across the industry. But I can't imagine considering one's self to be an asset manager and not ever buying shares directly.

TRUSTING: Is it not right then to think that the investor is better served by using funds? There is a whole army of asset management experts of the high tech industry. What, compared to them, is the value added through your own stock-picking?
J-M Genin: I bring my knowledge of the markets to the table. This enables me to say that choosing a few blue chips is no greater a risk than opting for a basket full of 50 or more different stocks, of which 20 are pretty much unknown and pose a great deal of risk.

TRUSTING: You don't trust the basket?
J-M Genin: Sure I do, but there are times when some stocks are really quite outside their historical price range. For example, they might be clearly under-valued. In a case such as this, the idea is to buy them with a three months perspective in mind. It's a trading strategy that cannot be applied while investing via funds as the cost factors of that route are simply too great. In the current market conditions, it is vital to bounce back and forth.

TRUSTING: Don't you think that the current trend is towards portfolio over-diversification. Last week, an ETF on Turkey went on the market. Which portfolio really needs to have the Turkish index?
J-M Genin: I agree. Diversification is wholesome and good, that doesn't mean that one has to cover every geographical zone and strategy. In the end one attempts everything and nothing, running the risk of losing sight of one's asset management objectives. Besides, one mustn't forget that the more one diversifies, the more one falls prey to a lot of follow-up work. And I don't think that one person can really manage today with more than around 50 funds.

TRUSTING: Among the investment tools that you use, you mentioned guaranteed capital products. How do you incorporate them into your portfolio?
J-M Genin: It's a fairytale example of what marketing can do!!! That being said, I think that guaranteed capital products should be in one's portfolio when everything seems to nearing the peak. This enables one to enjoy a potential increase and, in the case of a significant decline, the investment is protected.

As things stand currently, there is little justification for the use of guaranteed capital products, except for one instance. Let's say that I invest in Swiss francs over three years. I would have an average annual return of 1.5%, or approximately 5% over three years. In this case, if I opt for guaranteed capital, it would be in order to make things more dynamic. Rather than to say to my client that in three years you'll have 5%, I suggest that he take the risk of having a zero performance but possibly gains a return that would be far superior to that of bonds. This can be done by opting, through capital guaranteed products, for raw materials, crude oil, or stock indexes. But careful – I take this risk on a short-term basis, three years, because the capital is only guaranteed at maturity and, in the interim, prices of the guaranteed product can vary drastically.

Guaranteed capital products can't be used as a cushion. It is extremely expensive and, after commissions to the issuer , and retrocessions to the asset manager, little remains for the final investor.

TRUSTING: Would you take guaranteed capital on hedge funds?
J-M Genin: Yes, I would at the moment. Outside of funds of hedge funds proposed by big names and well-established promoters, I believe one must be very careful. In light of the swarm of new asset managers in the industry, I am inclined to think that we are in for some nasty surprises.

TRUSTING: Let's touch on traditional funds. Are they not over-diversified?
J-M Genin: One can't generalize. One mustn't forget that if you're an active manager, volume is fundamental. Today, there are more funds on the market than there are quoted companies. Thus, to have volume, active managers are essentially sentenced to over-diversification.

TRUSTING: The Swiss Federal law on investment funds protects the investor. The funds are required to clearly state their strategies, and offer high-quality reporting. Direct management has none of these constraints and therefore poses some "risk".
J-M Genin: Information provided by the funds is limited. For example, the final investor never has direct acces to the asset manager, if not the latter would spend all his time on customer relations. This is not the case in direct asset management as it relies on a relationship of trust between the manager and the client. And then reporting isn't everything. Look at Swiss, ABB, Parlamat, and others. Their reporting was first class, but in magic ink! ,

I believe that the client who desires daily reporting and permanent control must not hire an independent asset manager as that would mean that there is no trust between them, and, in this case, the manager's work would be futile. Having reporting is certainly a good thing, but one must also be able to analyze information and that is a profession in and of itself. For example : I really like cars. If one were to send me all the documentation imaginable about them tomorrow, I wouldn't be in any position to make an educated decision as the information would, for the most part, go right over my head.

TRUSTING: So reporting is almost like a booby-trap?
J-M Genin: Basically, it's a parachute that opens once you hit the ground!

Véronique Bühlmann


100% PRESTIGE
100% PERFORMANCE
TAG Heuer
WHAT ARE YOU MADE OF ?
STEVE McQUEEN AND HIS TAG HEUER MONACO
SWISS AVANT-GARDE SINCE 1860

Regulatory-mania Five senior investment managers give their opinion

Peter H. Buxdorf: England is very much on the forefront

"In England, there has always been an understanding that the U.K. was on the forefront of regulation," says Paul H. Buxdorf. His firm, Lacomp plc in Bagshot, specializes in portfolio fund management. In recent years the role of the Financial Services Authority (FSA) has been expanding, and it is no longer possible to engage in asset management without adequate supervision. "Such an obligation was needed since too many people were setting up while lacking an appropriate background." As far as the fight against money laundering is concerned, U.K. regulations are also very strict. "There is a huge discrepancy between the U.K. and Europe," Paul Buxdorf thinks. He is well placed to measure the gap, since he himself came from Switzerland many years ago. However fussy regulations may be, they are not always as effective as they should be, dwelling exceedingly on paperwork rather than on proper risk assessment. Compliance is not the only aspect of wealth management where the U.K. regulations have gone so far. Indeed, England is very much on the forefront of client compensation as well. Indemnity insurance exists since the 1980s, allowing for any client unhappy about the services which have been provided to him to file a complaint.
The firm is under an obligation to investigate, following such claims, and to offer appropriate redress. If he still not satisfied, the client can put the matter forward to the Financial Ombudsman Service which may instruct the firm to award him up to £100'000. Such compensations may in turn be covered by indemnity insurance, but even under fairly restrictive conditions, the market is far from attractive. Several insurers have withdrawn from the market which has shrunk, leading to a lack of capacity. Since every company engaging in asset management has to have an indemnity insurance for bad advice, costs are going up dearly. Undeterred by this and other debatable aspects of the British experience, European regulators are increasingly turning toward the U.K. for inspiration.

MF

Laurent Ashenden

Laurent Ashenden: toward a consolidation of the profession

"Quite a number of small asset management companies will have to merge in the coming years," says Laurent Ashenden, Managing Director of Ashenden Asset Management SA in Geneva. Even though regulations were needed at the outset to fill a void, obligation imposed by the law, especially as far as compliance and due diligence are concerned, is likely to prove too heavy a burden for many small asset management companies. Still one third of the firms active in Switzerland have less than 50 mios sfr under management, while costs are on the rise. An audit, under the new regulations which have lately come into force pursuant to the law against money laundering, represents up to 15'000 sfr charges, not allowing for the time consumed. At 5000 sfr a month per subscription to Bloomberg is becoming too expensive for some, at the expense of part of their credibility with clients. Now, asset management is becoming more demanding, not only as far as technical equipement is concerned, but also in view of further regulations which are likely to be enacted in a not too distant future. Thus, background checks and competence assessment are likely to be introduced on would-be asset managers which will make the profession less accessible to newcomers. Minimum capital requirements may be also imposed in the future, in order to make sure that companies engaging in wealth management are strong enough to face up to their responsibilities if needed. Last but not least, indemnity insurance, covering clients for bad advice or departure from agreed investment policy, is also on the regulatory agenda. Such a scheme, however will be very difficult to adjust to prevailing market conditions, so as to enable insurance companies to operate in a way that would prove both profitable for them and effective for the clients.

MF

Vicente Ferro: in the client's interest

"As professor Jean-Baptiste Zufferey has said, it would be advisable to set up an institution to oversee the operation of the non-banking financial sector as a whole," says Vicente Ferro, as Managing Director of the Groupe Beaulac SA, in Geneva. Cooperation with the authorities is of the essence for all financial institutions, since it would be very negative to show reluctance in the fight against money laundering. Appropriate means of gathering information in the process of due diligence do exist, even with clients based in remote countries. Custodians will as a rule oblige with data pertaining to the source of funds entrusted to them. To this effect, the two big Swiss banks entertain a worldwide network of subsidiaries, representative offices and correspondents. Moreover, other means of performing background checks are also available through specialized societies and data bases. Banks use readily a system such as World Check which allows for wide screening possibilities with its 2 mios names on file. Running names against such systems act as a first clearance even though it should be regarded more as a prerequisite. One always has to go back to the source of funds in the country of origin, and this requires the cooperation of the client. Sometimes, he will have to appear in person at the offices of a local subsidiary of the bank. Clients may not always be very pleased about this, but such caution works in their best interest.

MF

Jean-Claude Mourad: KYC should not be about only going through the motions

"One must differentiate between the letter of the law against money laundering, and what would really be needed in terms of financial security," says Jean-Claude Mourad, compliance officer of Suntrust Investment Company SA. As far as the regulatory environment is concerned, Switzerland is well endowed with legal instruments and codes of conduct. But the implementation is not always as effective as it should be. Indeed, excessive checks and needless paperwork may sometimes run at counter purposes with the alertness which a real understanding of the meaning of KYC would presuppose. Sometimes, financial intermediaries have to go through the motions for the sake of it, for instance when due diligence has to be performed three or four times for the same client, first by the bank, then by the asset manager, then by a lawyer. These and other aspects of the law should undergo a review. To this end, the establishment of a genuine "Financial Services Authority", such as exist in other countries, would certainly show progress. This new set-up would be only a first step since loopholes would have to be closed. There should be a rethinking of such a key concept as KYC, relying more on a better appraisal of the client's personality. Indeed, appropriate documentation should not always be taken as conclusive evidence of good character, and allowance must sometimes be made for other, less formal factors. Thus, asset managers are sometimes led to refuse clients who have already gone successfully through routine checks at the counters of a bank. Such checks do not shed enough light on what can be termed as the economic history of an account holder. Needless to say, such an alertness has a cost and represents an added burden for wealth managers. But the tendency toward increased sophistication will be felt by all members of the profession, even leaving aside the requirements of the fight against money laundering. In Switzerland, affiliation with a recognized association, pursuant to the law against money laundering, is still the sole prerequisite for managing assets. In France and in Monaco, however, companies have to meet minimal capital requirements, depending on the amount of funds under management. And that is not all: asset managers must be able to provide the client with a clear investment policy, adherence to which will be monitored by an audit firm. In Switzerland, things are undoubtedly moving in this direction.

MF

Franz de Planta: Self-regulation should remain the key.

Franz de Planta is Chairman of the OAR-G (Organisme d'autorégulation), that is the self regulatory body of the Swiss Association of Independent Financlal Adviser (GSCGI) and of the Geneva Corporative Employers' Association of Wealth Managers (GPCGFG).

As such the OAR-G, under licence granted by the Swiss Department of Finance in Berne, authorizes its affiliated members to exercise and supervises them as to the due fulfilment of their legal obligations and compliance with the Money Laundering Act (LBA).

He argues that reliance on self-regulation, as it is enshrined in the LBA, has sufficiently demonstrated its practical value over the last few years. Indeed, it would be paradoxical if Switzerland was to renounce a concept which increasingly appears as a model for other juridictions.

Self-regulation is no easy way and the costs it entails are fairly high for the 6,000 non banking "Financial Intermediaries" (or IFA's) registered as such with the Swiss Ministry of Finance.

Globally, the costs of compliance in Switzerland are situated somewhere between 1 and 2 billion Swiss Francs on a yearly recurrent basis. This burden might even increase in the future, as a prospective compensation could be levied as of 2006 by the Swiss Department of Finance to allegedly cover the administrative costs of overseeing the fight against money laundering and the expenses of its Control Authority (AdC).

This could add up an important extra financial charge for the self-regulatory bodies or OARs. While not very costly for a start, such a scheme would open the door to subsequent increases with uncertain limits on the upside.

Hopes are that there will not be a growing pressure on the existing OARs to fall in line with the politically thought out strategy decided in Berne, without making sufficient allowance for the experience of those who are immersed in the day-to-day activity of wealth management.

Thus, the Federal administration seems not to worry about the consolidation in the number of self-regulatory bodies making them less representative of what is regarded by the industry as vested interests. In the eyes of Franz de Planta and almost all the IFAs, compliance should on the contrary rely on professional organizations responsive to specific needs, so as to make them more effective in the global fight against money laundering.

Increasingly, the Administration's trend toward more regulation contradicts the avowed reliance on self-regulation. At the end of the day, the establishment of a large centralized authority to oversee the entire financial sector including banks and non banks, insurance companies and financial intermediaries, not only in LBA-compliance but in other matters as well, is likely to make the existing system redundant.

Wealth managers would have to spend an ever increasing amount of time discharging administrative duties and filing innumerable forms to cover against impending action on the part of hyperactive and evermore intrusive State agencies, thus soon outpricing the Swiss market place over their much less demanding partners about these same aspects in the global financial landscape.
Needless to say, such an environment would doubtlessly drive many clients away. And it will not really contribute to improve the market place Switzerland.

Mohammad Farrokh

The EU Financial Services Action Plan

Pay attention: the FSAP is destined to have a greater impact on your country's regulatory system than has been seen for many years. Be prepared.

(A keynote speech delivered on 1st October during the PIMS International Conference, reproduced with the kind authorisation of its author).

Let me first trail my coat. I am Chief Executive of APCIMS, the Association of Private Client Investment Managers and Stockbrokers. We have 229 member firms operating on over 500 sites with €400bn under management for the private investor. Last year our members did 13.7 million trades in equity for their clients.

Our members are firms and these firms employ some 10,000 regulated people – regulated that is to undertake investment business. Two years ago, the European Association of Securities Dealers, or EASD for short, voted to merger with our organisation. I think it is with some justification that I can say that APCIMS is the largest association of firms in Europe who act for the private investor.

Now the reason I trail my coat is because I am going to talk about the size and nature of the changes that are going to affect all European markets and financial firms regardless of size starting from next year – that is from 2005.

No EU country has responsibility any longer for policy relating to its financial markets. Decisions were taken by all our governments 5 years or so ago to place this responsibility with the European authorities and instruct the Commission to put together a Financial Services Action Plan, the intention of which is to create a single market in financial services across Europe.

Like so many announcements of politicians – and as an ex-politician I can say this with complete honesty and truth – these sort of high levels commitments are given with little understanding of what they are is going to mean in practice.

Charged with the responsibility of the FSAP, the Commission quite rightly decided that it needed to find a way of doing things rather quicker and rather better than it had in the past. Alexander Lamfalussy was asked to put together a group of "wise men" to come up with a method for speeding up the European directives process. He did so, and what is now known as "The Lamfalussy Process" has passed into the common language of Europe.

The Lamfalussy process proposed that directives should be short and consist of articles containing only high-level principles.
Then for a Committee of European Securities Regulators comprising the heads of every country's securities regulators to recommend technical details to be established. These technical details would be submitted to the Commission for inclusion in the directive and should be subject to easy and quick change as and when required.

National regulators were to implement these requirements with the intention of reaching a common goal. Lastly, there needed to be some enforcement procedures if a country did not implement or did not implement properly. Good process but with a couple of flaws. Firstly, it did not properly include the European Parliament which is the only European institution with a democratic mandate. Not surprisingly, the European Parliament decided through its EMAC Committee that it must get involved and, as they were removed entirely from input into the technical measures stage, then they would need to address theirs and the industry concerns by way of amending the directive itself.

The second flaw is that the process is not being properly followed. Let me explain by example. What is arguably the first major directive to be Lamfalussy-ed is the new Investment Services Directive (now known as MiFID) – the framework all our markets work within. It is in fact over 60 pages long. It was subject to much consultation with the market which is good, but many of the recommendations made by market practitioners were not included. When it had its airing in the European Parliament, the industry (wherever it was quartered) lobbied extensively. The European Parliament agreed a large number of very practical changes through amendments to the directive but sadly the Commission only accepted about half of the Parliament's amendments.

The directive was agreed by the agricultural commissioner and then arrived at CESR, the Committee of European Securities Regulators, for consultation of the technical measures. I cannot fault any of the European groups in terms of their consultation. What hampers all their consultations though, is that the EU is many countries with many different market practices and cultures. The absence of a detailed review of the various practices to determine what is similar and what is different in the first instance means that policy makers have been hampered by the absence of that knowledge. The result is that some changes may well be over-aggressive for some countries and unnecessary for others. The theory of open markets is good but if it badly affects a particular country's industry, then the industry and politicians get concerned and compromises made.

The likely outcome of the CESR proposals will be recommendations to the Commission that will have the result of increasing the size of the directive substantially.

There will inevitably be a great number of detailed changes to industry practice, from how a firm trades to whom they can trade with. From a client (or customer) agreement to the protections a firm gives them. From what is an exchange, a crossing network or ECN, to whether a trade is on market or off market. From what can be traded, and in what size, to price disclosure. And what is more those differences will be legislation with the power of enforcement behind them.

Not a lot will be left to national regulators and yet the role of these national authorities is vital because markets have grown up differently and there are more ways than one of getting to the end result.

In the Financial Services Action Plan there are 42 proposed changes and the Commission's well-publicised statement is that 39 of the 42 measures of the FSAP have now been completed. However, it is only the Commission that has finished as none of them have yet been fully implemented by the industry. The industry should not accept that this Financial Services Action Plan is nearly complete when for those for whom it is intended are yet to start their implementation.

I was honoured to be asked to be a member of the Commission's securities expert group. This was a group of about 26 individuals from most of the EU countries who met on several occasions in Brussels and produced a report on what should be the next changes for the securities industry. The practitioners in that group all had very similar views – a regulating pause was essential. Instead implementation of the FSAP in a clear, transparent, flexible and as sensible a way as possible was proposed. Systems to unmake what needs to be unmade was on the list, the need for transition periods and in future an evidence based approach to any new legislation was essential.

There will certainly be some benefits from the FSA, particularly for the wholesale firms. Although the big multinational firms already have managed to overcome most national barriers and in so doing provide a service for those who cannot overcome the national barriers as easily, for the mid-sized firms who may well currently have to use a big wholesaler in order to access certain countries in future, are likely to have better and cheaper cross border access than it has at the moment.

For many tens of thousands of firms though who fall within the definitions of MiFID, most of them do little or no direct cross border business at present and this will be slow to increase. For them in particular – and these include those who service the needs of the private investor – the costs will come early and the benefits could be as many as ten years out.

What is to be done? Well there are five things.

1. Give more time. The most expensive way of introducing something is to do it too quickly. If further time is given to the whole of the implementation process, and that includes the consultations, then change could be staggered and in so doing the cost of change could be much reduced.
2. National regulators and the industry need to trust each other and be trusted more by CESR. CESR has already brought everybody together; it has already started knowledge dissemination from one country regulator to another, and from the industry to all national regulators. Now CESR must trust those national regulators and the industry to get to the same end but by different means if those different means are more appropriate.
3. Understanding each other's differences is essential. Even now with the programme of change underway, if we understand each other's differences better then it is easier to create more appropriate technical measures.
4. Cost everything. I know that it is very difficult to do good cost benefit analyses but change does have a cost and so costing the benefits is paramount and is a process that has been sadly given too little attention to date.
5. The industry needs to participate and say what it thinks. If the industry lets the big idea go unquestioned then the industry can only blame itself for not having said early enough that the practical issues must have full consideration in advance of final decisions being made.

The FSAP and post FSAP is destined to have a greater impact on every EU country regulatory arrangements than has been seen for many years.

Angela Knight
Chief Executive
APCIMS

Is there a limit to taxation?

Clearly, the answer is: "yes".
"At 100% tax rate, any kind of economic activity would be pointless…" but what are the politicians doing seriously to limit the level of taxation?

Clearly, the answer is: "nothing" – or to be generous, rather little…
It is obvious that our European countries with tax levels of more than 50% of national output are experiencing serious problems and a general lack of confidence in the economy and more seriously for the democraty, the politicians in charge of the mismanagement of our interests…

The limit on taxes is probably what? 20% of national output? 30%?
As a matter of fact, in Europe, we find three players' leagues:
- Corporate tax less than 19% – most of the new EU member states
- Average corporate tax – 30%
- Big "spenders" – member states with corporate tax in excess of 36% – France/ Germany/Italy/Benelux

Will voters rebel one day as it happened in a distant past?
Some people think that high tax burden is the inevitable result of widespread democracy. When wealth was concentrated in relatively few hands, and the wealthy tended to control the government, they had no incentive to tax themselves. Today, most of the wealth is concentrated in the hands of the middle class, but apparently the middle class does not control the government…

The politicians have to attract voters by offering "goodies", spending on social security, health, roads, education etc. The money had to be found somewhere and taxes rise inexorably…

Taxes are a brake on economic activity.
There are adverse incentives to work, to save, and to seek and offer employment.
Social security benefits may make it pointless for workers to seek employment; hence a decline in the proportion of adult men in work over the last 30 years.

The high costs of collecting taxes and complying with the tax system undermine the workings of the machinery.

Taxes create a challenge to civic institutions encouraging tax avoidance and evasion. Taxes (and bureaucracy) are so excessive that the temptation is high to break the law even for any of us…

Many of us have built a growing exasperation over the way concerns over tax avoidance, crime money laundering and the financing of terrorism have resulted in an explosion of the regulation, compliance procedures and costs, with little or no regard for the efficiency of the measures implemented.

Let me be provocative: the solution may be tax-exemption for all savings and a free system that would allow the citizen the choice to pay for the entire cost of his retirement, the education of his children, and his medical care…

Today, our professional activities (advice and mediation) are penalised by extremely constraining regulations, the soaring cost of compliance procedures, the development of new technologies (rarely 100% reliable…), and the demands of a generally distressed and ill- informed clientele.

In 2004, financial advisers and financial intermediaries will collect worldwide more than US$ 300 billion worth of savings from the "mass affluent" individual customer segment with liquid assets between €100,000 and €1 million.

The "time bomb", which, in the very short term, is the pensions problem, reinforces the political need to attack the ensuing problems sooner than later, even if the politicians are showing an unfortunate reluctance for a more liberal European direction, and be more genuinely concerned with consumer interests, than certain national administrations might wish.

The failure of the state pension systems will open unprecedented prospects for European

financial advisers and intermediaries called upon to assist the anxious consumer in the right choice of options and alternatives for the sound management of his or her wealth.

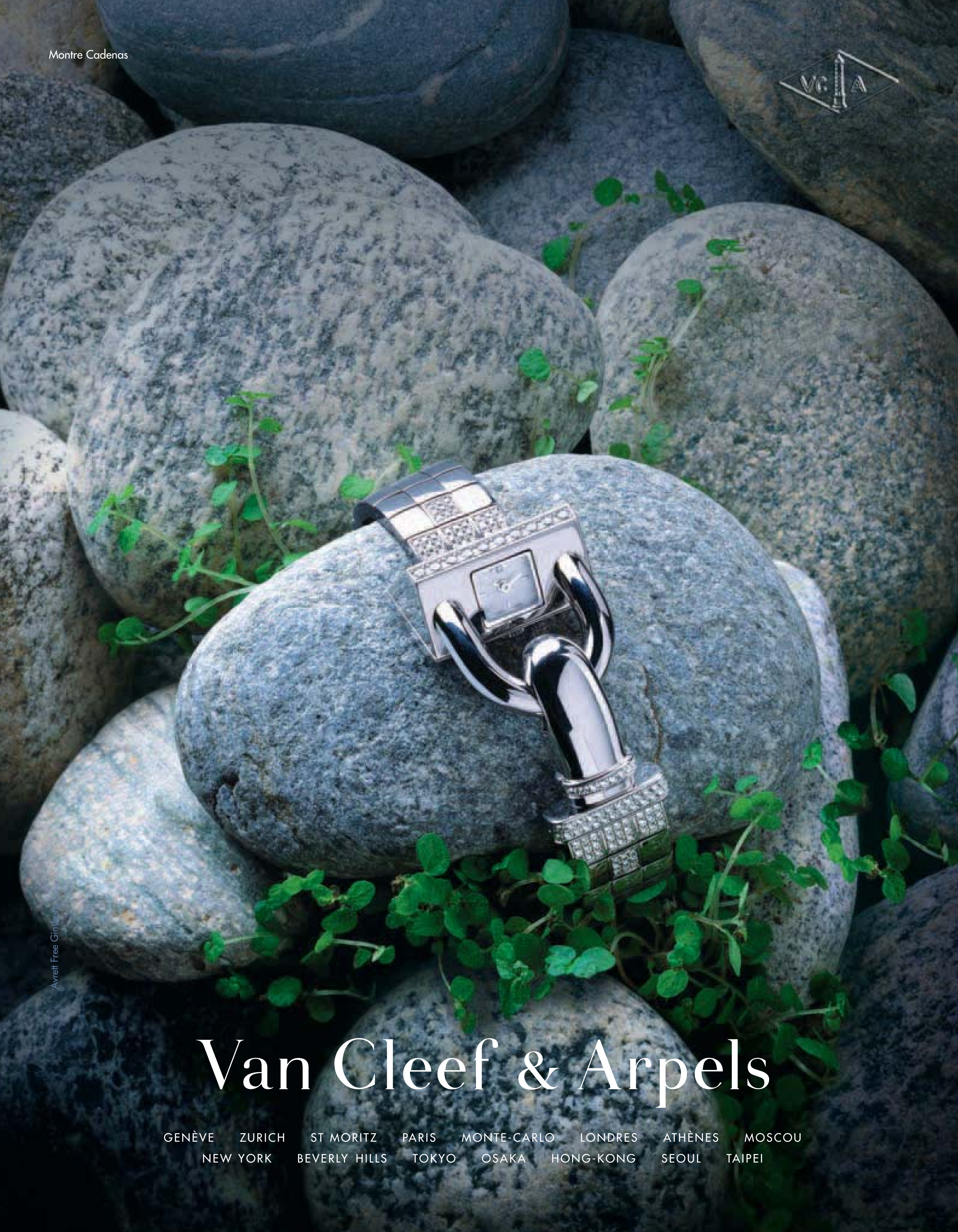
The European Commission plan addresses broader issues concerning an optimal single financial market, including the elimination of tax obstacles and distortions.

But, adoption of a minimum effective taxation that everybody would eventually happily pay from savings and implementation of a code of conduct penalising the politicians' "big spenders" would have be a strong positive signal. Unfortunately, the last Commission failed short of achieving anything in this respect…

Clarity of regulatory requirements, consistency (but not necessarily homogeneity), simplicity of application, maximisation of fair competition, to serve investors and citizens through increasing choice, the flexibility to encourage innovation should be the objective of the EU.

Needless to say that European legislation, made too often of political compromise, is far from meeting these goals.

Vincent J. Derudder
Secretary General
FECIF (European Federation of Financial Advisers & Financial Intermediaries)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International regulation
To encourage progressive convergence

"In this period of increasingly integrated financial market implementation, the issue of regulatory measures at a European level has now become paramount," stated Edmond Alphandéry before ceding the floor to the superintendent of French financial markets, Michel Prada, president of the AMF.

Numerous are they who call for the creation of regulatory measures at the international level, without pausing to carefully consider the legal and operational limitations of this battle cry. In the meantime, the press has taken this complaint and made it its anthem, sensationalizing the archaism and inefficiency of national regulatory bodies currently in place.

WHY REGULATIONS ARE NECESSARY FOR THE EU

In the last ten years or so, the consideration of international regulations for European markets jas become a categorical imperative, and for two reasons:
The first is due to the irresistible nature of cross-border operational development and the ineptitude of regulators to act only at the national level. More than a third of Euronext Paris' stock market capital is indeed tied up by foreign carriers, and the figure would be even higher were one to include CAC 40 companies in this equation. Consequently, the overseeing of market operations calls into question the presence of intecedants beyonds the border, a development which presumes that the scope of inquiry is being extended by cooperation with foreign authorities in order to restore the chain of outsider influence and obtain necessary explanations. Hence, in 2003, out of 85 inquiries launched by the COB and the AMF, 30 were conducted at the request of foreign authorities. However, as the COB addressed nearly 200 requests for information to its counterparts, half of whom were submitted for possibles operations d'initiés.

Another example – out of 9,500 funds offered to the public, 3,000 are funds of foreign origins; funds that are said to be "coordinated".
The second reason, no doubt more important in the eyes of those in the sector, is due to optimization of the cost and efficiency of the market system.
The fragmentation of markets that it linked to the preeminence of the national factor poses a handicap in light of their development and the reduction in the cost of capital. This is one of the main arguments of the Lamfalussy report and the plan of action in financial services launched by the European Commission in 1999.
On the other hand, international regulation would benefit competition and increase the field of operatives, thus encouraging innovation, economies of scale, and user access to a larger array of products and services.
It is therefore only logical to pursue the implementation of international regulations, which enables both the standardization of rules, the unification of their application, and the provision of a coherent interface for local operators' first steps in the international market.

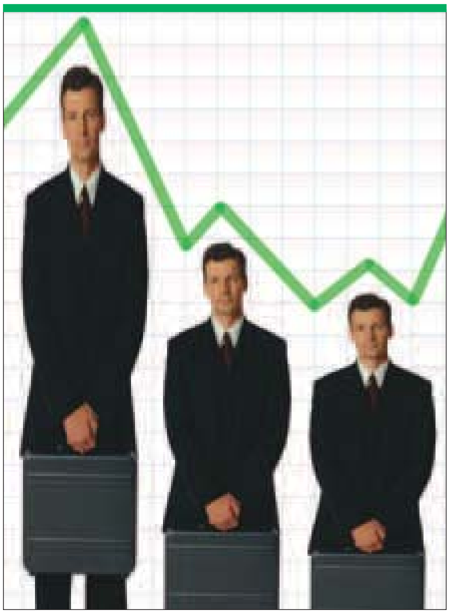
Without a doubt, no one still foresees the creation of a global market authority. But it is apparent that the issue is at least being talked about in political spheres such as Europe that are en route to integration.

… AND THE OBSTACLES?

International regulations must resolve certain difficulties that inhibit the planning of rapid operational integration.

First of all, I will insist that a fundamental distinction be made between the establishing regulations, which should remain in the hands of legislators and governments, and the application of these regulations which is handled by administrations and, increasingly, independent administrative authorities. Each must thoroughly understand that the market regulatory body only issues third level regulations and that a sole regulatory body, one that is Pan-European for example, could not secure, on its own, a standardized norm for everyone.
Consequently, I anticipate two types of problems which, in my estimation, make the unification of market regulation in the form of a supranational operational system an aspiration that is largely idyllic.

- The first obstacle arises from the principle of sovereignty which still influences relations among the member states. Market regulation, as with all social regulation, is based on a legal foundation for which it lacks the technical modalities needed for its implementation.
  Even in the context of Europe, the notion of sovereignty remains prevalent. Indeed, this trend arguably extends to the world at large.
  Certainly, the trend towards integration at the European level is advancing, but one can already see the difficulty and slow pace



that this requires. Hence, it would be absurd to daydream about total operational standardization for many years to come.

- There is second set of obstacles to tqke into account, factors that are much more practical and concrete in significance. Unlike prudential regulation which concerns defined professions and middlemen that are certainly numerous, though limited and responsible for the creation of specific and increasingly internally framed norms, market regulation is a daily affair, on the the infinite relations among all the entities that play a part in the market – businesses, investors, and middlemen from all walks of life – all engaged in the commerce of a host of products.
  Essentially micro-administrative in character, it assumes an optimal proximity to the site, operational decentralization, a capacity for direct communication that proves less favorable in cases of distant parties who are appear foreign due to their unique culture and language, whose very integration would require a monstrous bureaucracy that would quickly tire its users.
  Whatsmore, one must not forget that market regulation is executed in collaboration with numerous national and ministerial regulatory bodies, not to mention the representatives of associations that express the needs of the many players in a given market.

THE INITIAL STEPS TO TAKE

It seems to me that the adaptation of market regulations to accommodate globalization has to be conducted in keeping with a progressive and realistic strategy of creating a network of national systems intended to organize the convergence of concepts and regulations as well as operational cooperation among regulators. This is the starting point that has been undertaken since 1997 on a European scale, on whose history I would like to offer a perspective.

With the exception of a few directives, including the DSI of 1993, no system for interaction among European regulators existed in the mid 90s. It was upon this realization that, with Mario Monti, the idea for the Forum Européen des Régulateurs, FESCO, supported initially by the COB, which suggested its creation in Paris during its 30th anniversary celebrations in late 1997, was born.

Equipped with a president, a secretary general, a charter of cooperation, FESCO quickly got to work and suggested to the DG 15, under the direction of Georg Wittich, its second president, some ideas that were to constitute the future plan of action for financial services adopted by the Commission in 1999. What follows is actually quite remarkable. On the initiative of the French presidency, the "Lamfalussy process" is launched, validated in Stockholm, the creation of the European Committee of Securities Regulators, the CESR, in 2001, leading to the issuing of several major directives. Professionals who five years earlier had demanded the rapid standardization of the market, plead for "mercy" before this onslaught and the task of consultation and reform that it engenders.
As a side note, it is interesting to note that, in the five years since this all began, this aspiration has steadily deleted from its meaning, the clash of ideologies between the consumerist tradition of Continental Europe and the caveat emptor philosophy of the United Kingdom.

Now firmly established in Paris, CESR has done its homework in the banking and insurance sectors. It is breathing life into a network of regulators for which it is gradually becoming the central nervous system, with its triple role of advising European authorities, standardizing regulatory practices, and cooperating in an operational capacity in supervision.

One must go farther and, in keeping with what IIMG, the group of experts in charge of the evaluation of the Lamfalussy process', over which I had the honour of presiding in 2003, ensure to reinforce the CESR's authority, be it in the legitimization of its standards, the resolution of en conflicts that may arise between members, and the organization of a more integrated supervision of the market. Perhaps, later on, it will be necessary to have CESR assume the responsibility of direct regulation in areas that are clearly pan-European such as the recognition of rating agencies or the handling of some conglomerate cases.

GLOBAL PERSPECTIVES

Of course, globally speaking, we are far behind. And yet, who can overlook the progress accomplished since the 1997 Asian market crisis?

Encouraged by the demands of a market facing the 1997 Asian market crisis, Russia's in 1998, and then the net economy mayhem provoked by the scandals that occurred from 2001 to 2003, all global regulatory organizations intensified their efforts in standardization, using internationally recognized guidelines, and put the control of this process in the hands of their members.
IOSCO, IAIS, Comité de Bâle. All of these regulatory organizations constitute the architectural foundation of a global structure to which the participation of the IMF, the World Bank, the BRI and the OCDE, intergovernmental organizations, add credibility and coherence.

The Financial Stability Forum, created in 1999, a union of governmental, bank, intergovernmental, and regulatory bodies became something akin to the permanent General Secretariat of the 8 super powers, and consequently widened to accommodate to leading emerging nations such as Brazil and China. The meeting of the Evian summit in 2003 thus marked a remarkable step in the direction of international cooperation between regulators and the index organization of non-cooperative jurisdictions that compromise the inefficiency and the stability of the system.

To conclude then, it seems to me that one must consider international regulation realistically and willingness. A great deal has been done and a lot remains to be done. I would like to note that French regulators play a significant role in this effort which could not advance without the agreement of the Americans who, one must not overlook, "weigh" more than half of the world's total stock market capital.

Convergence is in the making. Bound to the principle of mutual recognition, it constitutes, in my opinion, the only secure path to take, even if it is slower, and more gradual than the theoretically construction of a more ambitious institutional framework.

As far as France is concerned, we have advanced in market economy and, to add to the debate, but we are lagging quite far behind our friends – the G4+1- the appellation for the international collective of "Anglo-Saxon" economies: the USA, UK, Canada, Australia, and New Zealand. It is less homogenous than it appears, but is nevertheless active, productive, and powerfully connected to the other financial communities close to the Commonwealth, Hong-Kong, and Singapore, among others.

In this context, it is evident that we must play the card we hold – Europe. It is in this context Paris must pursue its ambition of being present and recognized in the network of the main financial centers of the global market.

Excerpts from the writings of Michel Prada

Regulation: all risk and no reward?

Much has happened in international financial services in the past six months. Business confidence has improved as the economies of the world's richest countries have recovered, most noticeably in Asia, North America and the UK. There are still weaknesses in the economies of continental Europe, but the Organisation for Economic Co-operation and Development (OECD) is predicting real GDP growth in the eurozone of 1.8 percent this year, and 2.5 percent in 2005. Financial markets around the world got off to a good start in 2004, adding to the impressive gains of last year. "Improvements in global growth prospects and corporate finances, coupled with a robust appetite for risk, underpinned increases in equity and credit prices," says the Bank for International Settlements (BIS) in its first quarter review. "Not even further revelations of corporate malfeasance seemed to unsettle investors."

It would be hard to get more bullish than this, which is why merger and acquisition activity in the financial services sector has started up in earnest after two years in the doldrums. Much of this is confined to domestic markets, but we are seeing significant cross-border activity too, with banks and insurers pursuing acquisitions in Europe and the US. And there is intense activity in emerging markets, particularly in China which is drawing direct and indirect foreign investment into its banks and insurance companies. Unfortunately, with all this renewed activity comes not just the promise of reward, but the risk of failure. Market risk, credit risk, operational risk – you name them, all these risks and many more loom larger on risk managers' radar screens when their companies are in expansion mode. And in an environment of change and heightened risk the regulators are monitoring the situation ever more closely to maintain the stability of the financial system, prevent financial crime and protect the interests of customers.

REGULATORY RISK IS ON THE INCREASE…

So from a financial institution's point of view, regulatory risk must be high on the risk agenda. Despite globalization, we still live in a very diverse world when it comes to financial services regulation. In some countries, intensive regulation has been around a very long time, and although the issues change and best practice evolves, the art of compliance is generally well developed. But in others, where regulations and regulators are much younger – especially in the area of dealing with customers as opposed to prudential and capital issues – even the concept of a compliance function and what it should do is quite new.

It is key for readers in all regulatory environments – from the mature to the recently created – to understand the issues that affect them. Any firm that falls foul of the regulators faces not only having to pay fines and compensation, it also faces major reputational damage. In the US, we have seen very large fines and remedial actions imposed on major financial institutions for conflicts of interest between their research and investment banking activities, and on mutual fund companies for late trading and market timing abuses. In the UK, retail banks and insurers continue to be punished for mis-selling financial products to consumers. And in various jurisdictions, institutions have been disciplined for failing to comply with anti-money laundering measures. There are countless other recent examples of regulatory failure and regulator enforcement action across the globe.

…BUT THERE ARE REWARDS

So regulatory risk has become, perhaps, the biggest risk of all. But it does not have to be a case of 'all risk and no reward'. There are benefits to be had, if it is managed properly. If a bank achieves higher risk management standards under the new Basel Capital Accord, it will benefit from lower capital requirements. If, as insurance regulation moves to a more risk-based approach, an insurer handles its risk management issues effectively, it will become more capital efficient. If firms consider their compliance arrangements as strategically critical, there is great scope for benefits in technology leverage, business and functional integration, resource optimization and cost reduction.

If, in dealing with consumers, retail financial services providers take on the spirit and objectives of regulation, not just the letter of the law, there are great opportunities for reward from consumers with their continued custom and loyalty. And if groups set themselves, and demonstrably maintain, high standards of governance, customer treatment and compliance, they are entitled to expect the 'regulatory dividend' of less onerous and intrusive supervision from the regulators. We believe that regulators should be seen to be providing such an incentive more extensively.

REGULATORY RISK MUST BE MANAGED

We are dealing with a number of themes, but four in particular stand out. The first is the increasing globalization of regulation. There is an increasing degree of coordination between national regulators on policy, supervision and enforcement matters. The ripple effect should not be underestimated. On the other hand, detailed rules still differ widely from country to country. Both phenomena create extra risk for global groups.

The second key theme is the regulators' focus on effective corporate governance, the role of the board and especially the accountability of senior management, with regulators making it clear (in a variety of ways and with a variety of powers) that they will hold senior managers responsible for any significant regulatory failures in their organization.

The third theme is rising consumer protection. As Sir Brian Pitman, Senior Adviser to Morgan Stanley, pointed out at a European retail banking conference recently, "caveat emptor, buyer beware, is steadily being eroded in most of the western world." We are moving towards a principle of 'let the seller beware', with the onus falling on personal financial services firms to ensure that customers buy the appropriate products.

The fourth theme is the convergence of regulation across different financial sectors. There has been a trend, with notable exceptions, for countries to merge their various financial regulatory bodies into a single regulator. And although there are still big differences in the way different sectors are supervised, moves are being made in many countries to put all sectors on similar supervisory footings. One consequence is that an issue or expectation arising in one industry sector is rapidly extended across all other sectors.

But, as with all types of risk, there is an upside as well as a downside. The essence of any type of business – and financial services is no exception – is that if regulatory risks are properly identified and managed, then the regulatory environment can be turned to business advantage.

So regulation is definitely not 'all risk and no reward'. The rewards are there to be taken.

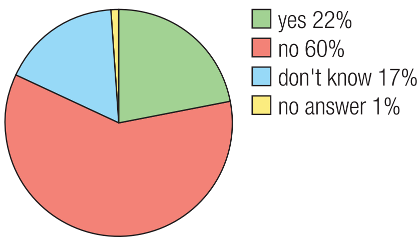
Financial services regulation is at different stages of development around the world. Readers in countries where it is a relatively new concept may want to learn more about what good compliance looks like. Readers operating in jurisdictions where regulation has long been a fact of life may want to benchmark themselves against best practices operating in other companies to ensure their regulatory risk management is up to scratch.

Brendan Nelson, KPMG LLP (UK) Global Chairman, KPMG's Financial Services Practice

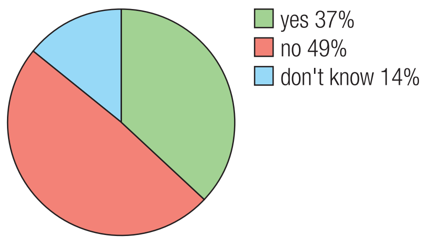
Switzerland: enough regulation

Last summer, KPMG Switzerland commissioned a survey on the regulation of the Swiss economy and the trust in its business leaders. The survey shows that the Swiss people do not want more regulation. However, the confidence of the Swiss in their business leaders is rather weak.

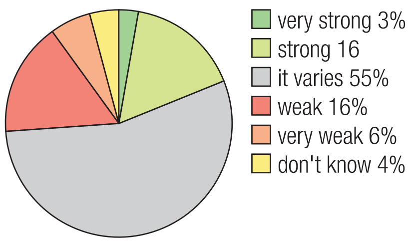
Do you want the State to impose stricter laws on business?



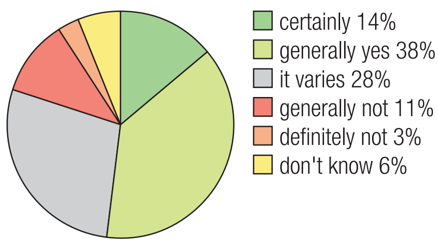
Do you want the State to control business more strictly?



How strong is your trust in Switzerland's business leaders?



Do you believe that the Swiss business community generally complies with the basic rules of ethics and the law?



Source: Gfs-Zürich Markt- & Sozialforschung

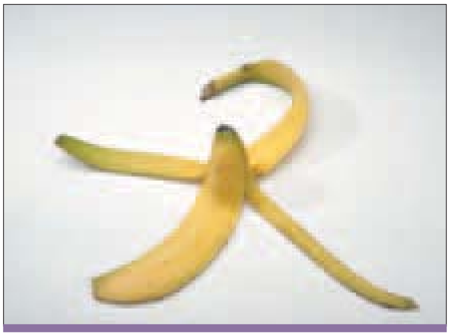
Accidents waiting to happen: Junk bonds, Chinese stocks, reits, etc.

Financial markets are nothing but the anticipation of value changes. The whole problem of these predictions' made by the market lies in the fact that they are submitted to the investors perception. According to Charles P. Kindleberger, in Manias, Panics and Crashes: A History of Financial Crises crashes and crises are created by irrational market behavior.

Regularly, large numbers of investors become concerned about losing money at the same time and scramble to liquidate their position. They are therefore subject to the dominant subjective opinion about the future among them. This is why markets can often react very rapidly to any type of factors (sometimes even non correlated to the investment). When markets are brusquely and adversely affected, they face a crash. Are these accidents predictable? Why do they happen? What are the current risks?

FULLY IRRATIONAL

Some accidents are totally unpredictable like the assassination of Kennedy in 1963 that provoked a crash in the financial markets, but had no economic implications. It was therefore fully irrational in financial terms. Most of these unpredictable accidents only generate opportunity for the savvy buyer. They should not worry investors as a whole as they have no long term impact. The question is totally different when an accident is due to a change of perception that is linked to an unperceived but real asset overvaluation problem. In such a case, it is commonly said that a financial bubble has developed and that the crash is a reaction to it. This has happened frequently in the past. The Dutch Tulipomania in the 17th century, the British South Sea bubble in the 18th and the 1929 crisis have all generated many analyses. It has repeated itself recently in the 1987 Japanese crash or in the 2000 internet one, etc… The consequences of these crashes are often a financial crisis and it takes a certain time for investors who have been scared off by their losses to come back to the market. It is therefore much more interesting to try to anticipate these events and to identify existing bubbles.



Irrationality and the herd like behavior of investors (or their misperception of potential economic returns) are certainly one of the causes of these bubbles, but it is certainly not the only one. As Kindelberger demonstrated, the easy availability of money has always accompanied the bubbles. Sometimes, this is even worsened by corruptions of the financial system. This has been the case in the Roaring 20's, in Japan in the 1980's and more recently in the Dot.com boom and bust.

Since 1980, the monetary mass (M3) grew at a yearly rate inferior to 7% in the United sates according to the Federal Reserve. It accelerated to more than 10% between 1998 and 2001 As the dollar is the world reference currency, this growth might very well have fueled the dot com bubble. The current yearly rate for 2003 and 2004 is under the 4,5% threshold. This argument is therefore less strong than three years ago. Probably one has to look at the easy money sources elsewhere if there are bubbles currently existing or in the making.

THE RISK OF A CRASH

We will try to analyze if some of the assets enjoying the reputation of having boomed recently have in fact developed a bubble. We will do it for the Chinese Stock markets, for the private investments in China and India, for the commodity markets and more closer to us for the junk bonds and for the real estate investments.

In 2000, the Chinese stocks rocketed 136,6% at a time when most markets were depressed by the fall of western tech stocks. In 2002, these markets have experienced their first real fall since their inception in 1990. The question remaining is to know if these fluctuations are just due to the high volatility of these markets or if there is still a risk of a crash looming.

The yuan peg to the dollar, officially meant to protect the Chinese banking system from falling apart, is preventing the yuan from revaluing itself, creating an excess of liquidity domestically. Conscious of the risk, the Chinese have tried to tighten their monetary policy. In July 2004, the growth of M2 was reduced to 15.3% which is 5% lower than eight months before. At that time, the Chinese foreign reserve reached US$ 483 billion. This is more than three times their level 6 years ago. There is no doubt that the monetary condition enabled the creation of a bubble.

The PER of Chinese technology companies listed on the NASDAQ are high, between 20 and 35. Although this may sound quite high, one has to take into consideration two moderating factors: most of them seem to be enjoying very high growth and they are in a highly volatile environment: From June 2003, the Hang Seng China Enterprises Index passed from 2500 to 5,391.280 on January 5th, 2004. since then the market has been falling and has even reached 3,546.250 in May 2004 and has recovered since then being at the end of September higher than 4500. From the available information it is therefore hard to say that there already is a Chinese bubble.

THE CHINESE FINANCIAL SYSTEM IS STILL FAR FROM EFFICIENT

But there is no doubt that the Chinese financial system is still far from efficient, as the legal and fiscal environment is very complex with many different classes of stocks.
The reduced number of stocks in class B (listed in dollar and open to foreign investors) limit their liquidity and create differentiated prices with the "A" stocks of the same company. This is even worsened by the fact that some "many fraudulent companies report false earnings and boast the popularity of their products to innocent investors" according to the China Investment Newsletter.
We might end up discovering at one point that as the Chinese corporate information is not reliable, the prices are in fact far over their actual value.

This situation is probably even clearer in private equity in China and in India. Together, They accounted for USD 2.1 billion in private equity investments in 2003. This is the same amount as in Australia, even if the latter has a much more developed economy and structured financial infrastructure. According to one of the FDI specialists in Mumbai, "nobody is really looking for investors anymore: there is too much money available and managers are becoming peaky when it comes to conceding time to investor representatives." But at the same time the Indian economy starts to face difficulties in providing sufficient trained personnel to fuel the boom. This should soon create some cost increase in the sectors concerned hence reducing the competitive advantage and probably at one point creating a real financial problem to the investors that have come to fuel the bubble.

The commitment of international private equity investors in China nearly doubled last year as this country is considered as a new heaven for investors as there is an important deal flow (plenty of new technology companies fuelled by the local universities and most state owned enterprises needing a turnaround) as it is possible to exit the investments on the Hong-Kong Stock exchange, on NASDAQ and on the NYSE. But the story is not so easy, problems can arise at: identifying the right target, obtaining a fair valuation of the companies, having a certain degree of control over the participating companies, finding and maintaining talents, exiting the deals if NASDAQ investors become reluctant one day to accept new Chinese equity. Even though it is less visible than on a stock market, we might currently have a bubble forming in the private equity sector dedicated to China and India.

The Chinese industrial boom has created a strong increase in commodities and in oil prices. As its financial market, this is fuelled by the financial capacity excesses of the country. For example, its oil imports have increased by around 40% in the first eight months of 2004 in comparison with the same period of the previous year. As a result, its oil bill increased by 64% pushing up world oil prices to record highs. This has been true in the past year not only for energy prices but also for other commodities like iron ore leading to a high inflationary pressure as Chinese wholesale prices rose 9,5% in the twelve months to September 2004. Even if this increase in prices is due to a change in economic equilibriums and a higher demand of the Chinese industry, this industry is partly financed by a nearly bankrupt banking system. It is growing thanks to a competitive labor force, whose cost might rise if inflation is effectively developing as the currency is pegged to the dollar!

Even if any inflationary pressure on industrial goods has been wiped away until now thanks to the huge increment in Chinese low cost production capacity, the high money availability might have created another type of inflation in western economies: the one of assets. The annualized growth of Credit in the United States in the first nine month s of 2004 have been higher than 9% and real estate loan has risen 14%. During the first quarter of this year, home mortgage borrowings reached an historical level representing 5.5 times the average amount of the 1990s! Lenders are now putting a pressure on 10-year Treasury note futures as they are deeply in need to hedge their position. The money factor to create a real estate bubble in the United States is no doubt here. The average price for new house sales went up from $ 175,000 in 1997 to $ 250,000 in 2004 according to the census bureau and the real estate industry has, in the same period of time, more than doubled its volume to reach $ 2,000 billion according to the National Association of Realtors.

THE CURRENT BUBBLE

In fact, it has been the same in most western economies. The Banque de France recognized that the current prices were much higher than the ones of 1991 in real terms (the last real estate bubble). Spanish real estate prices have gained more than 120% in seven years...
With a lack of other interesting investments available, institutional investors have followed suite and this has led to the huge growth of Real Estate Investment Trusts. As a result they have even reinforced the current bubble.

The murky financial structure that sometimes exists in a bubble might come from US government sponsored enterprises (GSE) like Freddie Mac, which had to review its accounting procedure in mid 2003. Another one, Fannie Mae, which used creatively hedge accounting as demonstrated by the inspection by the Office of Federal Housing Enterprise Oversight which pointed that at the end of 2003, Fannie Mae notional derivative position had reached $1.04 trillion and $ 12.2 billion in deferred loss related to its cash flow hedge! This will certainly open a new area in which GSE will reduce drastically their leverage and, as a result, the market might be left without its security net in term of last resort buyers.

TOO MUCH CASH AND TOO LITTLE PROFITABLE INVESTMENTS AVAILABLE

For the same reasons as those of the development of the real estate bubble (too much cash and too few profitable investments available), the junk bonds (high yeld bonds rated under BBB) have known a new golden area in the past two years. In 2003, investors bought a record of $125 billion worth of junk bonds doubling the 2002 issuance according to Thomson Financial. The whole issue is to know if the tightening of the monetary policy by the Federal Reserve, the interest spread will not reduce itself at a time when the insolvency rate might increase due to more difficult refinancing. Anterior issuance booms (1990 and 2001) resulted in afterward a high default period.

The current instabilities generated by the overflow in money availability worldwide has enabled certain asset classes (China stocks, Chinese and Indian private equity, real estate, junk bonds, etc.) to grow very quickly in size and in price. This gives good reasons to "bears"to think that these assets might be heading for a fall that could shake the whole financial system like the Peso crisis in 1982 or in the Asian currency in 1997.

François-Eric Perquel
Financial Consultant

The main reasons to invest in emerging markets

In order to know why to invest in markets of emerging countries, it would be useful to explain what they are. Even if many lists of these countries are available, it remains hard to define why they are emerging.

In order to know why to invest in markets of emerging countries, it would be good to explain what they are. Even if many lists of these countries are available, it remains hard to define why they are emerging. There have been many definitions of emerging markets since the inception of the expression in the 1980's. At first, it was thought of as a way to describe the financial markets of countries like the "Asian tigers" whose economy actually started to take off. Now, the more generalized definition is the one used by the World Bank and the IFC, which turns out to be a politically correct description of the lesser developed countries. As a result, all the countries that are not considered developed fit into the lot. This increases the range of countries concerned and the complexity of a rational analysis of them and therefore it becomes essential to understand why invest in them.

"MODERN PORTFOLIO THEORY"

Diversity is the best way to characterize investments in these emerging markets:

- They form a macro asset class which includes nearly all types of traditional asset classes. This is due to the fact that their definition does not come from the type of investment vehicles but from the geographical place where they are used. Apart from fixed income (sovereign and non sovereign) and equity assets, they also encompass forex, derivatives and private equity. Some even include commodities in the picture!
- It is also geographically very diversified as it covers countries on nearly all the continents and with totally different macro-economic patterns.

This diversity has a main advantage. It fits very well the investors need for investment diversification to improve its return and reduce risk according to the so-called "modern portfolio theory". However, one has to remember two hypotheses: This theory works in efficient markets and with uncorrelated assets. As a result, one cannot be 100% sure that the diversification works for this asset class as the emerging markets are far from being efficient. They tend also to be highly correlated when there is a crisis at the time when people need them to be uncorrelated. As a result the diversification is an interesting argument but it remains imperfect.

A better argument lies perhaps with the higher returns one can expect from a more risky environment. This will have to be proven depending on the asset class. We will review it for fixed income and equity.

Like any other fixed income, the cost of the debt is highly linked to the possibility of the corresponding debtor obtaining a certain rating. Even if rating agencies are far from being perfect, they all tend to be highly cautious toward countries which do not belong to the most developed ones' club. Hence the rule of thumb that higher risk is related to higher reward tend to be true in this asset class even if it is to be analyzed on a case by case basis to see if the extra reward compensates for the additional risk.

NOT SO EVIDENT

In the case of equity, things are not so evident. Companies tend to operate in more difficult environments and to be less transparent than the ones in financial markets of developed countries. Most of them would only qualify as mid or small caps in these markets. It is therefore essential to have primary quality information about these companies and their environment. On average, the returns of emerging equity markets do not offer a premium that really offsets the risk. ADRs and GDRs are only American or international synthetic securities that replicate the stock of one company. Their only advantage lies in the fact of being legally American or international instruments, of being listed in a hard currency (generally the USD) and, therefore, of enjoying better market conditions (reduced transaction cost and sometimes more liquidity). This advantage is often paid at a sensible premium to the underlying equity.

Adding to the former advantage of a higher return (at least in fixed income), emerging markets tend to offer discounted asset values. They are also another possible opportunity in these countries. In the case of fixed income, the reason why such a discount might appear is highly related to the evolution of the market appreciation of the default risk of the debtor. This is normally more or less reflected in their ratings. It is therefore difficult to speak of a discount related to the theoretical market value in fixed income except in specific cases. In equity, this tends to be different: due to the already mentioned issues (harder environment, company transparency, profitability and eventually size) emerging market corporations often have strong assets. The share value ratio to assets tends to be lower than in western companies. In the cases

of utilities and raw material extraction (oil and mining), the substantial discount to assets is a reason to invest in theses countries invoked by many specialized managers.

EMERGING MARKET CORPORATIONS OFTEN HAVE STRONG ASSETS.

This main issue with emerging markets is to know if it is a never-ending situation or if some countries can become mature and how. If Africa has never really started to take off (perhaps with the exception of South Africa) and if South America is maintaining itself in a self-perpetuating cycle of booms and busts, there seems to be more hope for European and Asian emerging markets.

In the first case, the European integration in the European Union has enabled countries like Spain, Portugal and to a lesser extent Greece to quit the emerging countries category and to be recognized as developed nations. As a result their assets have revalued themselves dramatically over the past twenty years. This could also happen with the Central and Eastern European countries that are now entering the EU, and perhaps Turkey in a not so distant future.

THE CAPACITY TO TAKE OFF BY THEMSELVES

In the second case, some Asian countries have demonstrated the capacity to take off by themselves following a model that has been Japanese in the first place. This model is based on the use of low labor costs and currency undervaluation to boost imports in a first stage and to reinvest the proceeds of the profits into improved productivity to innovate and to generate a local market for goods. This system has proved highly successful in Japan, in Korea, in Hong-Kong and now it is adopted nearly everywhere in Asia including in China. It is not without risks, as have demonstrated the Japanese and the Korean crises which have had not only a tremendous local effect, but also some repercussions worldwide. This raises the question of a Chinese crisis in the process of this type of taking off.
The emerging markets are certainly not efficient: There are tremendous inequalities in the access to information and that is why it is essential to be well informed to be active in these markets. The best informed might have in the quality of their information a reason to invest in them.

As a whole, it is easy to see the risks linked to investing in emerging markets, but it is not always as easy to find ways to compensate these risks. In fixed income this seems a bit more obvious than in equity which except for companies from Asia and from countries entering the European Union does not tend to offer a suitable compensation for it.

François-Eric Perquel
Financial Consultant

They want to hold your hand

Independent financial counselors offer guidance in a hazardous shareholder culture

The stock market bubble of the late 1990s was not kind to Al, a retired furniture designer living in central New Jersey. He had entrusted a lifetime of savings and investments to a big brokerage firm near his home, and when the bubble finally burst, he found he had lost close to $230,000, nearly two-thirds of his nest egg.

Many people lost a large portion of their savings during that period, but Al, who asked that his full name not be used, felt particularly aggrieved. His money was lost largely on investments far beyond the risk he says he had agreed to assume, and most of those investments were in mutual funds belonging to the brokerage firm.

On top of that, he later discovered, much of what ought to have been profit was swallowed up in commissions and fees to his stock broker. After the dust cleared, Al asked around and found Eve Kaplan, a former fund manager who now runs a small independent financial advisory service in Berkeley Heights, New Jersey, called Kaplan Financial Advisers.

Kaplan is one of the growing breed of independent financial advisers – counselors unaffiliated with any bank or brokerage firm who help individuals with their financial planning for a fee.

Once, such advice was available only to the very wealthy, who had financial lives complex enough to need it and pockets deep enough to afford it.

In today's shareholder culture, though, more investors need sophisticated and personalized advice to know how best to diversify their portfolios and survive in an uncertain market.

The independent adviser does not have to sell any product. He can truly be impartial.

And with personal computers and the Internet making sophisticated analytical tools cheaply and widely available, personal financial advice is now affordable even for people with moderate incomes.


YOUR MONEY

They want to hold your hand

Independent financial counselors offer guidance in a hazardous shareholder culture

Fallen from their pinnacle, growth stocks show value

Many of these individuals have relied on stockbrokers to manage their money – a reliance encouraged by many of the big investment houses, which often use the term "advisers" to refer to their brokers.

But as more investors like Al have felt burned – and as the links between advice and a firm's other businesses have come under scrutiny by regulators – independent financial advice that comes without strings attached has become increasingly popular.

"The independent adviser does not have to sell any product," said Thomas Muldowney, the president of Savant Capital Management, a small firm of independent advisers. "He can truly be impartial."

The first thing Kaplan did was pore over Al's brokerage statements and showed him what he had paid in fees. She also helped him consider alternatives like outsourcing his portfolio to a manager who would rebalance and monitor the portfolio for a nominal fee – 20 basis points, or two-tenths of one percent of the assets under management.

Kaplan's role was to oversee the portfolio manager – an "extra set of eyes" as many advisers call it. For this, she charged a flat fee that was set out in advance and not tied to the investments she advised Al to buy.

"It's all about transparency," Kaplan said.

Independent financial advisers can be found around the world, but the most developed markets appear to be the United States and Britain, the two countries with the most dynamic shareholder culture. In the United States, the National Association of Personal Financial Advisers is a group of about 1,100 practitioners who are subject to state securities regulations.

"The function we perform is one of counseling," says Richard Glickman, a partner in Family Office Advisers, a two-person advisory firm in New York. "We look at the total wealth posture of a family and help them create a long-range wealth picture of the family – the houses they own, insurance policies, stocks and bonds, annuities."

Glickman and his partner, Charles Comer, take a holistic approach, looking at "the total wealth posture of a family" to create a long-term financial plan. They help clients select insurance policies, mortgages, and even accountants and lawyers. But they draw the line at picking stocks or other individual investments because, Glickman said, receiving commissions from the institutions selling stocks or mutual funds could put him in conflict with his clients' interests.

"We are not selling anything," Glickman said. "We simply make sure all the parts are talking to one another."

The British profession is organized slightly differently from its U.S. counterpart. In Britain, advisers, who number about 10,000, work out of independent firms but accept commissions from the banks, brokerages and insurance companies whose products they sell. Some 60 percent of all life insurance, private pensions and personal investments are sold through such firms, according to industry figures from IFA Promotion, a trade group. The profession is regulated by the Financial Services Authority, the national market watchdog.

The key to financial success, say many independent financial advisers, lies not in picking the stocks or mutual funds that will outperform the market, but in understanding what impact the fundamental forces of the economy can have on a client's financial goals, and distributing investments – from homes to stocks – to take advantage of those forces.

What this boils down to is asset allocation – how much of your portfolio to keep in stocks, bonds and other investments to meet your goals.

"Asset allocation is 90 percent of the story," Kaplan said.
"What you own is only 10 percent."

This may sound like something most investors can do for themselves – and, in fact, it is. But allocating assets can be complex, and the portfolio will need to be rebalanced to take account of changes in the investor's cash needs, goals and tolerance for risk. Most individuals, advisers say, do not have that kind of staying power.

"People aren't so much lazy, in my experience, as reluctant to work on anything financial," Kaplan said. "It gives some people a terrible taste in their mouth and they let inertia take care of their asset allocation needs. You can imagine the drift over time away from an optimal mix."

Typically, an independent financial adviser will hold several meetings of an hour or more with a potential client, discussing financial history and financial goals.

"If you came to see me," said Susan Spraker, a financial adviser in Orlando, Florida, "you'd be here between one and two hours, talking with me about why you are here and what you are looking for, what you have done in the past, why you're looking for a change and your history of handling your investments."

The aim, Spraker said, is "put a price tag on your financial goals."

"We help people try to get on track, talking about what they want to achieve and how realistic the goal is," she said. She will "look at what the portfolio needs to do and what they need to add to the portfolio to get there."

Ron, a social worker and consultant in Orlando, Florida, with an annual income of about $80,000 and a net worth he estimates at about $500,000, signed on with Spraker two years ago. He said his previous financial adviser, from a regional brokerage firm, had stuffed his portfolio with stocks like Enron and WorldCom, even as their prices hit rock bottom.

Spraker rebuilt his portfolio, helped Ron save money on a car (she found him a deal on a year-old used car) and health insurance, and gave him a clear financial plan for the years ahead.

"She can be very honest with you, not pie-in-the-sky," said Ron, who also asked to be identified only by his first name. "She said, 'Here is what you are going to do when you are 60, 65, 70 and so on.' That's not my forte and I don't expect it to be."

Not every adviser can work well with every investor. "It's a courtship," said Michael Haubrich of Financial Service Group in Racine, Wisconsin.

Frances Bedford had let her husband handle much of their joint income – she was a music teacher and he was a professor of English literature. When he died suddenly, she learned that at Haubrich's urging, her husband had set up a trust fund to support her. Haubrich also helped Bedford later sell her house and navigate the tricky tax and financial waters of her remarriage. At his suggestion, she even took some of her inheritance and established a scholarship in her husband's memory.

"That was a real basic transition of life – along the way he was a very objective adviser – both of those transitions there involved substantial amounts of money and he showed me how can you maximize it to eliminate the risks," Bedford said.

Haubrich said he might charge $1,500 for an initial set of four to eight meetings to discover the client's financial history and needs, then charge an annual management fee of $5,000 to $10,000.

Not everyone wants such a strong guiding hand with his or her personal finances. Do-it-yourselfers can turn to an online personal asset manager called Financial Engines, devised by William Sharpe, the Nobel economist from Stanford University who developed the concept of capital allocation. Originally designed to help fund managers allocate assets efficiently, Sharpe took his concept to the general public. Used mainly by large firms to help employees better manage their finances, Financial Engines is available for about $300 a year to individual investors. The company says many advisers use its Web site to balance their clients' portfolios.

Peter S. Green

Illustration by William Rankin

Insight into the work of a self-regulating body

The "VQF" – the Association for the Quality Assurance of Financial Services (a vocational organisation of Swiss Asset Managers supervised by the Swiss Government) – was the first self-regulating body (SRO) recognised by the Control Authority for combating money laundering. It complies with the Money Laundering Act (GwG) for financial intermediaries, which came into force on 1 April 2000, pursuant to Art. 2 Paragraph 3 of the Money Laundering Act (GwG). Since that point in time all financial intermediaries in Switzerland must comply with the obligations of due diligence implicit in Art. 3 and thereafter of the Money Laundering Act (GwG). Since then, they must undertake either to become an affiliated member of an SRO or submit to direct monitoring by the Control Authority for combating money laundering (Kontrollstelle). No financial intermediary is allowed to operate any longer in Switzerland without an affiliation of this kind or without a licence from the Control Authority.

Over 1,600 of the approximate 6,000 licensed Swiss financial intermediaries are affiliated to the VQF. More than a quarter of all Swiss financial intermediaries are thus accountable to the VQF. The majority of the others are affiliated to the other 11 self-regulating bodies. Only around 270 are directly subordinate to the Control Authority.

These figures impressively illustrate the importance which must be attached to the self-regulating body in the fight by the Swiss financial centre against the risk of being used for money laundering. In order to manage this fight as successfully as possible, the self-regulating bodies have at the same time been assigned various different tasks and duties.

IN-DEPTH AUDITS

Their primary legal duty consists of effectively checking that their affiliated members are complying with the obligations of due diligence by means of regular controls. In this respect the VQF is successfully pursuing new methods – despite occasionally encountering official suspicion. It is the first, and so far the only, self-regulating body to have developed a so-called "risk-orientated audit concept". Instead of stubbornly keeping to a set annual rhythm of controls, it puts its members in risk categories with the help of the respective individual audit reports. The date of the next audit is determined on the basis of these assessments. It varies as a rule between 1-3 years. More importantly, small companies benefit from this, once they have proved that they take their duties seriously and also proved that they do not, for example, become mixed up with "risky" customers. They save themselves substantial audit costs, if these audits do not have to take place on an annual basis, thanks to their proven seriousness. In order to guarantee the efficiency and quality of the controls, the VQF makes particularly high demands on the audit system. Apart from its own auditors which it employs, it entrusts only an exclusive circle of personally accredited external auditors with this task. These people undertake to take part in the vocational training offered by the VQF and to carry out a minimum number of audits per year. The VQF determines which auditor audits which member. A financial intermediary therefore cannot pick and choose his Money Laundering Act (GwG) auditor himself. The VQF also demands very detailed audit reports, which are all taken off by the members of its supervisory committee and individually analysed in terms of risk category. Last year the VQF carried out over 800 audits.

The audits can also have serious consequences. Penalties are imposed on members who do not fulfil their duties. This is also the legal duty of a self-regulating body. The penalties range from reprimands to fines and can lead to expulsion, which can have very serious consequences for a financial intermediary. Without affiliation to a self-regulating body or a licence from the Control Authority, it could no longer operate. Over the last few years the VQF has handed out over 100 penalties and also resorted to a few expulsions. It is also crucial to eradicate the few "black sheep", who unfortunately occur in every occupational genre, and can harm the entire financial centre of Switzerland. The most effective way, of course, would be not to allow them to operate from the outset. With this in mind the VQF has deliberately stepped up the acceptance procedure, which has recently led to an increase in rejections.

ON-GOING EDUCATION AND FURTHER VOCATIONAL TRAINING

The clearly pleasanter work of the SRO is the on-going education and further vocational training of its members. The main focus, of course, is the training required in connection with implementation of the obligations of due diligence. In this respect it is crucial to make financial intermediaries continually more aware of the current risks and dangers–also with practical examples–and familiarise them with the constant developments, including constantly amended national and international specifications. Although the legislator has only obliged the self-regulating body to check the educational/training standard of its members, by concerning itself with the education and further vocational training of its members, the VQF nevertheless considers it more in the sense of Quality Assurance than as a matter of course. Its members must undertake to undergo further vocational training on an annual basis, and this is permanently monitored. The VQF trains around 1,500-1,700 financial intermediaries every year in almost 30 events. In addition, the VQF operates a homepage, in which it informs members about the latest news in the scope and province of the Money Laundering Act (GwG). A pamphlet appearing 2-3 times a year containing current contributions rounds off this information system. The VQF convincingly makes light of the huge associated cost, because only well-informed and trained financial intermediaries who have been made aware of the impending risks will guarantee that our financial centre can operate with a "clean bill of health" and is not used as a happy hunting-ground by criminals for their dishonest business.

We should also mention the daily (predominantly phone) consulting service for members. The hotlines have been particularly busy concerning new unofficial reports from the Control Authority on the subject of who should be regarded as a financial intermediary, and under what circumstances. An important service also offered by the VQF is its assistance in critical situations. The specialist, individual advice of the VGF is greatly appreciated, more especially in terms of the delicate matter of whether there is sufficient evidence for suspecting potential money laundering. After all, it is then a matter of reporting a customer to the authorities, accusing them of possible money laundering. Last year, VQF members reported more than 40 of these kinds of suspicions.

The VQF fulfils these core tasks with around a dozen employees, compared with state supervision, where the Control Authority employs six people in the section responsible for around 270 financial intermediaries which are directly accountable to it. They do this without any feeling of responsibility for educating and training these financial intermediaries themselves, and delegate audits to another independent section or external auditing authorities.

Hans Baumgartner
Chief Executive Officer VQF

The Swiss Association of Asset Managers (SAAM)

If Switzerland is excelling in one particular economic sector it certainly is rendering financial services for high net worth individuals. In the course of time it has developed into a symbol for Swiss excellence. Speaking of financial services one inevitably associates asset management, which in private banking has top priority. Also in respect thereof the financial centre Switzerland occupies a leading position by international comparison, for which we are envied by many countries.

Doubtless the big banking establishments are occupying the "pole position" in the private banking industry. It would be decidedly wrong, though, to infer that the part of independent asset managers is of no real importance for our financial market. Latest estimates assume that the market share of these specialists has increased in the course of the last 15 years from 3 to 10% of all the assets managed in Switzerland. Said share approximates a sum of 400 billion francs!

PRIME BUSINESS PARTNERS

Independent asset management in the important position it currently occupies in the Swiss private banking industry – and is set to occupy in the future as well – would be unthinkable without a representative professional association. In 1986 the Swiss Association of Asset

Managers (SAAM) was therefore established as a professional association in order to accompany its members, assist them and inform them about all activities of the industry.

The mission of SAAM also consists in explaining and commenting complex laws and regulations as well as the latest market developments and products; on the one hand in advanced training programmes and forum, on the other hand in regularly published professional articles. The SAAM keeps offices in Zurich, Geneva and Lugano and is committed to the highest standard of quality, professionalism and ethics and its own rules of professional conduct demanding irreproachable exertion of their business activities.

With 780 active members and over 60 banks as passive members the SAAM constitutes a prime business partner and interlocutor for the public authorities as well as for all other participants in the banking centre Switzerland. The members are divided into approx. 600 one-man companies and 200 legal entities with up to 100 employees each. The volume of assets under management ranges from some 100,000 CHF to several dozen billions. 275 active members are based in the French part of Switzerland, close to 100 in the Italian part and close to 400 in the German part. SAAM is an actor who doesn't lose sight of the constant new challenges in view of an increasingly significant international competition.

INDEPENDENCE, FLEXIBILITY, TRUST

If the SAAM has become indispensable for the Swiss financial centre it is also due to an increasing demand for independent asset management. Those clients who care about a trusting relation to their financial manager have come to appreciate the independence, attention and friendliness of an independent asset manager. Since it concerns one of the most demanding clienteles with regard to material and personal accomplishment, the asset managers joined in the Swiss Asset Management Association have been able to continually complete and widen their professional knowledge.

SOPHISTICATED SERVICES

Independent asset managers and members of the SAAM usually are professionals with profound experience acquired in one of the big Swiss banks. Conscious of their commitment towards the clients (clienting) they exercise their mandate exclusively in their interest, respecting the contractual liabilities like loyalty, transparency and due diligence. According to latest developments in the private banking industry the client's expectations are becoming more widely spread and complex with regard to extensive and long-term financial planning: wealth-, tax- and inheritance-planning have to be included, if necessary by consulting external specialists. It is not surprising therefore, that about 7,000 people – employed by almost 2,500 Swiss companies – are committed daily to furnishing added value in the field of global wealth management.

SELF REGULATION AND CODE OF CONDUCT

In addition SAAM fulfils a crucial task implementing the Swiss anti money laundering law, enacted since April 1st 1998. According to said law financial intermediaries are obliged to be regulated by either the Money Laundering Control Authority (Kontrollstelle) or by privately organised self-regulating organisation. In accomplishment of said law SAAM has set up its own self-regulating organisation recognized since 1999. It supervises all affiliated financial intermediaries, i.e. asset managers, ensuring the correct implementation of the Swiss anti money laundering law and, if necessary, to emanate sanctions. The self-regulating organisation of SAAM is constituted by the executive board. The code of conduct contains a listing of all duties appropriate to efficiently combat money laundering as well as the rules for professional ethics, indispensable to warrant high quality wealth management for high net worth individuals. Only when these rules and requirements are fulfilled will the Swiss financial centre, with its high ranking standards, continue to keep the "pole position" that it owes to a substantial part to its independent asset managers.

The Institute of Financial Planning (IFP) at a glance

The Institute of Financial Planning is the UK professional body of those committed to the development of the multi-discipline profession of Financial Planning. The vision is to achieve recognition for the Financial Planning profession.

The Institute was formed in 1986 to:

- Promote the profession and practice of Financial Planning
- Increase public awareness of the need for Financial Planning
- Create a recognised professional qualification for its members
- Ensure ethical standards through its Code of Ethics and Code of Practice
- Ensure professional standards through its Practice Standards for CFP® Licensees
- Encourage education in the theory and practice of Financial Planning
- Share members' knowledge and skills with other professionals for the benefit of their clients
- Establish a Registry of Certified Financial PlannerTM licensed practitioners

The Institute's mission statement is:
"to develop and promote the profession of Financial Planning to the general public and to those people involved in providing advice

Nick Cann, Chief Executive of the IFP

and guidance to their clients, in order to most effectively fulfil every client's financial and lifestyle objectives".

The Institute of Financial Planning Ltd is a not-for-profit company limited by guarantee and has no shareholders. The Board of the Institute is made up of individuals from a variety of practice backgrounds and with a variety of qualifications. All serve in a personal capacity – there is no representation from regulatory bodies or from any of the many professional bodies represented in the membership. Membership of the Board is restricted, to those members of the Institute who are qualified to minimum of Certified Financial Planner licensee level.

The Institute of Financial Planning is a sitting member of the Financial Planning Standards Board (FPSB). This international body, which was launched in London in October has over 45,000 qualified licensees Worldwide, and includes similar standard setting organisations from Austria, Australia, Brazil, Canada, France, Germany, Japan, Korea, Malaysia, Singapore, South Africa, Hong Kong, India, Taiwan, Switzerland and New Zealand. The Council exists to:

- promote the professionalism of individuals and organisations offering personal Financial Planning services
- ensure that such services are offered in an ethical and competent manner throughout the world.

The Institute of Financial Planning has the exclusive rights to the CFP licence in the UK.

The Institute is multi-disciplinary in its membership. It draws its members from the related disciplines of accountancy, insurance, taxation, stockbroking, education and legal professions, amongst others. It is keen to continue this mix of different professionals and to encourage business relationships between members who have come to Financial Planning through a variety of routes.

The synergy of these major professions within one body will lead to the emergence of new multi-discipline professionals who can be proud to serve their clients in a way unheard of before. The Institute is committed to the development of such individuals.

Membership is available to anyone interested in the development of Financial Planning as a profession or in their own professional development. All levels of entry from student upwards are available. The Institute has high standards, but it offers membership to all who are interested in:

- Aspiring to higher standards in education and ethics.
- Achieving higher standards (by taking examinations ultimately leading to the Certified Financial Planner Licence).
- Adhering to those higher standards (by embracing the Code of Ethics and Professional Practice).

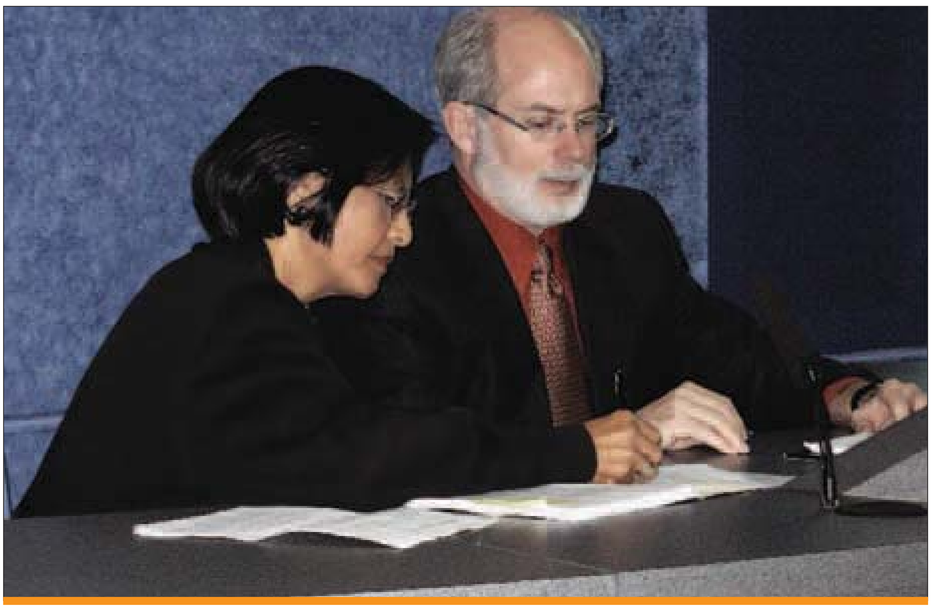
The Institute exists to encourage the highest possible standards of education and ethical behaviour and believes that it is only by membership of a professional body such as this that this can be encouraged. A special scheme operates for young members (under 25).

Membership offers a wide range of benefits, including regular meetings at local branches. There are 16 branches at present. Such meetings offer an opportunity to develop technical, interpersonal and business skills. Meetings are usually held in the evenings, but some branches hold occasional half-day workshops as well.

Professionally qualified Financial Planners who fulfil a rigorous set of additional requirements are eligible to apply for Certified Financial Planner Licensed status, entitling them to use the designatory letters CFP. The Certified Financial Planner has additional duties in addition to the general requirements imposed upon members, including a willingness to abide by the detailed Code of Ethics and Professional Practice, and undertake continuing education. CFP Licensees are also able to use the CFP trademark.

The CFP Licence is not a "get it and forget it" qualification. It must be applied for each year, and renewal is conditional upon the ethical and educational requirements having been met and after full disclosure of any complaints against either the Licensee or anyone supervised directly by the Licensee during the last year.

Nick Cann
Chief Executive, IFP



Maureen Tsu, Chair of the FPSB, and David Diesslin, Chair of the CFP Board of Standards, signing the licence at the recent launch of the FPSB.

The financial services regulatory framework should be open yet firm

One of the attractions of being in a member state that has just joined the EU is that the nation starts with a clean slate concerning regulation. This however, is also one of the worst characteristics of a new member state.

Here in Cyprus, the introduction of a set of rules for the financial services industry comes to a market of 600,000 people. It also comes to a market which has been a currency exchange controlled economy since 1974.

The existence of directives passed by the EU Parliament mean that any regulator has to adopt the technical aspects of the directives. Regulators may be potentially judged however on the way the spirit of a directive is employed, and in a state with little development of financial services for the public this measure is as important as the former.

That there should be regulation as to the investments available to the public is clear. That there should be effective controls over the manner in which investment opportunities are presented to the public and over the practises of the firms that deal with the public is equally clear. What is not clear is when do such controls upset the market place between adviser and client.

Regulators are a fast breeding progeny of modern government. Dealing in the implementation of law rather than the framing of law they are therefore appointed rather than elected and hence are impartial to the public. Yet being human they bring their own prejudices, and therein lies the danger, because their prejudices and perceptions are not subject to public disapproval. They only normally are replaced upon death, retirement or more worryingly, when they have caused the framework they were regulating to fail. Quite quietly the regulation of financial services may be one of the most important regulatory features of the next 20 years or more. Governments have at last admitted that the social system envisaged in the 1950's and 60's is now unaffordable. People, the EU citizens, cannot rely on their governments to care for them. This is not only in retirement, but extends to medical and social care. Simultaneously governments are suffering from the reduction of taxation that has accompanied the 80's and 90's and are facing lowering taxation revenues with tighter fiscal constraints being imposed by monetary unification.

In a nut shell, Governments need people to save. Governments will also have to realise that they should not be the savings depository of the people and thus should aim to remove themselves from the arena, concentrating largely on the well being of those incapable of caring for themselves and incentivising those who are by framing simple and attractive tax allowances. To assist this, the financial services regulatory framework should be open yet firm. The government needs the public to save; the government funds the regulator; ergo the regulator needs the public to save; the regulator needs to make access to financial advice easy and ensure that the products available are tightly monitored. The regulator should never be a judge.

Financial advice will soon come into the core activity field of financial services under the 2004 directive, and by 2006 should have been implemented by all member states. The regulator should remember that being able to explain the interest swaps being held in a hedge fund and how they will react if equities rise by 2% is what the regulator should be hearing from those who design and manage investment products. It is not what the person wishing to save for his pension or his childs' university education wants to, or needs to, hear. What is required there is clarity, disclosure and understanding of the individuals requirements and how they may be achieved within the social framework. Frankly the interest swaps are easier to regulate on, the latter probably lies in the spirit.

Richard Stevens
Board Member of CIFSA (Cyprus International Financial Services Association)

Singapore, one of the world's leading financial centres

Since its founding as an independent republic in 1965, Singapore has developed in such a way as to be considered today one of the world's major financial centres.

This growth has come from a country that is politically stable and has a well-educated and qualified work force of professionals together with a highly efficient business infrastructure. Today Singapore boasts over 600 banks and financial institutions and has been the traditional banking center for Asian clients and now with increasing demand has become a preferred financial centre for non-Asian clients. As a result, SG Private Banking has set its Asia-Pacific regional centre in Singapore.

THE REGIONAL HUB IN ASIA PACIFIC

Within this framework, the Wealth Management Industry has over the last few years developed at an ever-increasing pace with private banking assets estimated to be in the region of USD150 billion at the end of 2003. Private Wealth Management now encompasses both active advisory, discretionary portfolio management and fiduciary services and with a resultant increase in the numbers employed in the industry.

Within the development of Private Wealth Management there has also been an increase in the number of Approved Trust Companies so that at the end of 2003 there were 16 such companies. There continues to be further strong interest from financial institutions to establish a Singapore based and regulated trust company. Many financial institutions have made Singapore the regional hub in Asia Pacific for their wealth management business.

With this growth, Singapore is continually seeking to improve the regulatory framework and at the same time have clients consider it as one of the pre-eminent jurisdictions for the establishment of trusts and related structures for the purposes of inheritance and tax planning together with asset protection. The Monetary Authority of Singapore ("MAS") has been in the forefront of these developments with the overall aim of reducing the risk of abuse for money laundering and other illicit activities, screen out incompetent and disreputable service providers and promote the growth of the trust industry as well as the broader private wealth management business.

To aid the development of the Trust Industry a Trustees Amendment Bill containing proposed changes to the Trustees Act was released for public consultation in June 2004 together with the proposed introduction of a Trust Companies Bill.

A MORE ATTRACTIVE FINANCIAL AND TRUST CENTRE

The proposed changes aim to make Singapore a more attractive financial and trust centre in the international arena. The key changes proposed are:

- Introduction of a Statutory Duty of Care;
- Introduction of a General Power of Investment;
- Introduction of Powers to appoint Agents, Nominees & Custodians;
- Changes to Forced Heirship Rules;
- Other changes will include amendments to a trustees' power to insure, powers to delegate, introduction of a fixed perpetuity period, clarification on the laws relating to dispositions to defraud creditors and changes in the laws on accumulation of income
- Whilst these changes will impose a further burden on Trustees they will as well make Singapore a more attractive jurisdiction particularly for those clients coming from Civil Law jurisdictions i.e. Continental Europe and Central and South America. Whilst certain areas of the proposed law could inconvenience those clients who wish to be more involved in the management of investments there are provisions that would allow the Trustee to accommodate these clients' requirements.

SINGAPORE HAS NEVER BEEN ON ANY OF THE LISTS OF NON-COOPERATIVE JURISDICTIONS

Add to these the fact that Singapore has never been on any of the lists of non-cooperative jurisdictions issued by FATF, the EU and OECD and is not viewed as a tax haven being deemed to have a comprehensive tax system. For many Latin American countries such as Mexico, Argentina and Chile to name a few, Singapore is not viewed as a tax heaven and does not feature on these countries "black lists".

Given the above, SG Private Banking (Asia Pacific) has noted a steady flow of funds from the traditional European centres for management to Singapore. In response to this, we offer extended access to all its services; in addition to the team of professionals in Singapore available during both European and Asian working hours, private bankers based in Europe assure responsiveness and quality service. Well versed in the major European languages and with a global network, we also offer all services covering trust, estate planning and wealth management services.

Additionally, SG Trust (Asia) Ltd noted changes in the Trustees Amendment Act Bill together with the proposed provisions to be contained in the Trust Companies Bill will ensure that the Trust Industry in Singapore will be regulated and administered to a high standard of professionalism and competence.

Further planned legislation will cover the issue of Business Trusts (to allow greater flexibility in the management and control of active businesses) and Limited Liability Partnerships. Both when utilised together with other areas of legislation, i.e. the amended Trust Law and amended Companies Law, will only add to the ability of Singapore to provide the appropriate solutions to many clients requirements when structures for estate planning, inheritance planning, financial engineering are being considered.

Recent changes in the Companies Law will also serve to make Singapore companies more attractive. We have highlighted the following major changes:

- Only one director required but there must be one who is resident.
- Corporate directors are not allowed.
- Single shareholder who can be a corporation. Director may also be a shareholder.
- No annual audit required for dormant or small exempt private companies (a turnover of less than S$ 5,000,000).
- A full tax exemption on first S$ 100,000 of reportable income for newly incorporated companies (available for the first 3 years).
- Private companies may by resolution dispense with an AGM.
- Additionally income earned abroad by a non-resident company is exempt from tax even if remitted to Singapore.
- There is no withholding tax on Singapore dividends.
- A non-resident company cannot benefit from Singapore's tax treaty network. This is only available to a resident company.

Tax cuts and exemptions in the 2004 Budget have sought to ensure that Singapore remains competitive and attractive to foreign investors. Principal among these has been the exemption of income of a foreign trust or eligible investment holding company established for such foreign trust of which the trustee is an Approved Trustee Company or is providing trust management or administration services.

Additionally for foreign investors looking at Singapore as a centre for placing part of their assets as a non-resident such individuals do not suffer capital Gains/Profits tax, there is no tax on interest income or dividends on Singapore dividends, no Estate Duty (other than on Singapore immovable property) and no tax upon the entry or repatriation of funds. All these advantages should make Singapore an ideal centre for investment.

Pierre Baer, Executive Director and Vincent Magnenat, Senior Vice President Global Wealth Management SG Private Banking (Asia Pacific)

Direct investment
An Attractive Strategy for Returns

In the increasingly diversified investment landscape, how can one approach emerging markets beyond the classic forms offered by the official markets? Is the solution in direct investment, and if so, how?

I am writing this article while in Istanbul where PRI has been active since 1999. Turkey is just one of several examples of developing economies that attract relatively little foreign direct investment, compared to the opportunities that it offers. It has a population of almost 70 million and world-class companies in dynamic Export, Construction and Tourism sectors. It has not yet reached FDI of $2bn per year. It has opportunities that can absorb multiples of that. However, very few of its companies have experience dealing with foreign investors and lenders. And most foreign investors have no idea, or the wrong idea of the opportunities the country offers and its culture. As usual, a bridge is needed.

NEWS OF THE DAY

Since the fall of the Soviet Union, and even a few years earlier, volatility and crises have become a global phenomenon. We are linked to each other's problems by satellite TV and waves of money going in and out of markets as a reaction to the news of the day. The largest crises have hit the largest and most "stable" economies. Almost $1trillion in equity disappeared from the US during the years of the Savings and Loan crisis which followed the Tax Law change of 1986. While the more recent dot-com, Enron and other corporate revelations crises were of much smaller proportions, they were clear reminders that "political stability" does not guarantee transparency and safe investment.

Within the next few years we are likely to experience another major crisis in the US, which will impact on many other economies. The unprecedented debt and trade deficit situations are worrisome, at a minimum. The problem of the virtual disappearance of the mid-sized industrial sector by 2006 is very real and will not be solved by the next President.

In the 90s and early 00s, we lived through economic earthquakes in Mexico, South East Asia, Japan, Russia and Central Europe, Turkey and Argentina. We will continue to experience major peaks and valleys. We are creating them by pushing and pulling vast sums of capital, in and out of Markets.

> "Political stability" does not guarantee transparency and safe investment

On the front page of the October 14 issue of the Financial Times the main headline read: "Emerging market borrowing boom. Bond issuance of 270bn Euros breaks last year's record with two months to run. Institutions seek refuge from poor returns elsewhere. Warning of risk in oil price. The amounts are not really impressive, when we look at the actual size of the "Emerging Markets" and their needs, but the statistic points to the making of yet another wave driven greatly by the eagerness to achieve better returns.

TO ELIMINATE SOME OF THE MYTHS

The time is right to eliminate some of the myths and to prepare Investors and their representatives to diversify and get involved in direct investment opportunities in Emerging Economies. There are many small and medium size (often large, by local standards) quality companies and projects in countries outside of North America and Western Europe. They present as good, if not better, opportunities for investors than the stock markets where they have been playing.

Direct Investment in Emerging Markets offers IFAs and Private Bankers diversification from the usual target markets and instruments. From time to time clients are interested in becoming involved in a certain country that seems interesting and promising. The challenge is to be ready with the right relationships, on the ground to be able to participate in the opportunities.

The question is how to choose where to go and how to get involved in a productive and profitable way.
How do you take your clients there? What are some of the obstacles that need to be overcome?

You will choose the country or region depending on the profile of your clients and the distance that your resources allow you to travel. Distance and lack of local know-how are the main obstacles to safe direct investment. Finding compatible and experienced local associates in the country of choice is critical for success.

ESTABLISH YOUR NETWORK

Co-Investors: From our experience, the Investor who is new to a market benefits from co-investing in a well structured transaction, where a local Investor, say a Fund with a local presence, is interested as well. It is easier to do due diligence on someone else's due diligence than to do your own. In all countries where opportunities exist, there are International funds that have local infrastructure. Among their concerns, when they consider Investment proposals, are returns and exit. Yours are likely to be the same.

Due Diligence Required:

Review of Comprehensive Information about the Project, outlining:
• Uses of Funds
• Target Markets and Rationale
• Management and Organizational Structure
• Marketing and Sales Strategy
• Manufacturing Process and Equipment
• Advantages of Geographic Positioning
• Financial Projections and Valuation

The International Finance Corporation of the World Bank also has local or Regional offices in most countries worth considering. They are being approached by many companies looking for Investors. They do thorough due diligence. Some of the projects that they turn down are actually worth looking at through more entrepreneurial eyes. Pay them a visit in Paris and get a reference to their country manager. EBRD and EIB are also active in the same markets and sometimes co-invest with the IFC. The most interesting to your clients may be the Investment Funds established by private organizations, which are more flexible than the multilaterals.

Lawyers: Contact a law firm that has solid experience working with International Banks and Investors. They would be eager to answer your initial questions, especially if they are a well established local firm.
Banks: There are always Banks that stand out from the crowd. They are either top quality Domestic Banks or International Banks with domestic presence. They have senior executives responsible for international relationships. They are always prepared to meet and share their knowledge. Since they live in the country, they are often cautious about their recommendations.

Travel: Go to the country. Be a tourist for a couple of days. Feel the people. There is nothing like the reality on the ground. It beats analysts' and country reports, or at least it complements them nicely.

SIGNIFICANTLY HIGH RETURNS

In the early stages of your involvement in a country, you may want to focus on the world of Exporters that have demonstrated that they have the capacity and quality standards that satisfy international customers. The professionals that you will be contacting will know who is who and will be able to comment on the credibility of the companies.

All the above assumes that you wish to be proactive so that you become a sort of "specialist" in certain markets. If you prefer to be reactive to opportunities that come to you, identify the people that you will need to be associated with and let them know what type of opportunities you are interested in seeing. Do it in writing and be as specific as possible.

THE RISKS CAN BE QUANTIFIED

Direct investing is an opportunity to offer your clients a truly innovative asset class, apart from simply diversifying into "Emerging Market" stock funds, which are often mature local blue chip firms with minimal growth opportunities. This is a play on convergence with the developed markets, rather than looking for the potential of a superior business model, or sustainable low-cost manufacturing advantages, or unique local products that will be in demand from import markets worldwide.

Victor Politis, President and CEO
and Eric Stambler, Senior Vice President

PRI Project Development LLC, a 10-year old New York based firm that develops projects for its clients in "Emerging Markets", obtains Strategic Partners, Equity and Debt financing for their implementation.

How Google entered the Stock Exchange

By any measure Google is an exception. Originally its name was a play on the word googol, a word referring to the number represented by the numeral 1 followed by 100 zeros. If many new leading products have seen their name become the generic name of the product they represent like Kleenex, it has become a verb, to google, meaning to look for (on the internet). Except for a one million dollar seed financed by friends, family and fools in 1998 and a first round at $25 million in 1999 by Sequoia Capital and Kleiner Perkins Caufield & Byers, the company has never raised any more money during the internet crisis. This originality is also to be found in the way it carried out its IPO.

A ONE MILLION DOLLAR SEED FINANCED BY FRIENDS, FAMILY AND FOOLS

Its first filing with the SEC in April 29th, 2004 generated near euphoria with investors. It was the first really significant IT IPO since the bubble burst in 2000. Its originality was not so much in the IPO but in the way it was to be carried out:

- without splitting the share ahead of the offering to reduce its value,
- opting for an original Dutch auction process, that disfavors the underwriters obliging them to cut fees by half and not enabling them to offer the shares to their best clients and
- making a few legal mistake including not stating some of the personnel stock options, giving an interview to Playboy during the silence period.

As a result, the critics of the offering were vocal and the filing was restated on Wednesday August, 18th to reduce the number of offered share to 19,6 million from 25.7 million and the offer price to $85 when the original range was between $108 and $135.
Nearly 30% of the shares were sold by former shareholders. Most of the main Wall Street names were involved in the operation (Morgan Stanley, CSFB, as joint book-running managers. Goldman, Sachs, Citigroup, Lehman Brothers, Allen & Co, J.P. Morgan., UBS, WR Hambrecht and Thomas Weisel Partners) and the main shareholder ended up being Fidelity! Merrill Lynch is the sole intermediary which refused to participate in the deal under such conditions even if it was the biggest ever technology stock IPO

After so many difficulties in the IPO process the shares quoted $100.01 on their debut on NASDAQ a 17.8% surge. On October 4th, the share price reached $135, which was the highest limit of the first proposed valuation… which was probably not so bad.
The example set by Google in the process will be hard to follow for other IPO candidates with less bargaining power, but there are smaller underwriters that might be willing to change their business model to adapt to this new possibility and gain market share.

François-Eric Perquel
Financial Consultant

Private Wealth Management

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