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A foggy day,
In london town,
It had me low,
And it had me down
I viewed the morning,
With much alarm,
The british museum,
Had lost it's charm
How long I wondered,
Could this thing last,
But the age of miracles,
It hadn't past
And suddenly,
I saw you standing right there
And in foggy london town,
The sun was shining everywhere

"A Foggy Day," by George Gershwin, with lyrics by Ira Gershwin from the 1937 movie, "A Damsel in Distress"

{ What are the fishermen (aka managers) saying across the pond? }

Some members of Convergent's Investment Strategy Group were recently in London meeting with long-only, long-short and multi-strategy managers to gain perspective on their outlook and what they view as potential opportunities in the current environment, and how that may differ from the outlook held by managers based in the United States. Despite the gloomy turmoil gripping Europe, the opportunities described by some of the managers made it seem like they felt the sun was shining.

LONG SHORT EQUITY MANAGERS

We met with several long-only and long-short equity managers while in London and found them to be far more optimistic than we expected, certainly more optimistic than U.S. based managers were about the European economy and markets. The majority of U.S. based managers have significantly decreased their exposure to non-U.S. securities, specifically those in developed Europe. After discussing many of the top names in the portfolios of managers we visited, it was clear they had a higher focus on where companies were generating their revenue than U.S. based managers. While most managers pay attention to revenue details, it was more consistently cited as a significant driver of the investment thesis than we typically see. European exchanges, specifically the London Stock Exchange, are home to a significant number of global and multi-national companies which requires managers to regularly look at cross-border revenue streams. Many of these companies generate a significant portion of their revenues from outside of developed Europe which has allowed many to remain attractive despite the issues in the countries of domicile. When analyzing companies from this perspective, the outlook is more optimistic and even more so for those companies generating revenues from emerging markets. In addition to using revenue information as the basis of investment, managers of both long-only and long-short funds use this to hedge currency exposure back to the base currency of the fund.

MULTI-STRATEGY MANAGERS

The multi-strategy managers provided a much deeper look into the differences between U.S. and European markets, specifically when it comes to credit. European credit markets are smaller, less liquid and unbalanced by security type when compared to the United States credit markets. For example, the U.S. credit market is roughly 51% bank debt and 49% fixed income securities compared with Europe where credit markets are approximately 87% bank debt and 13% fixed income securities. Europe remains behind the U.S. in requiring banks to deleverage and mark assets to market. This has caused a further deterioration in credit market liquidity as banks continue to hold debt on their books to avoid taking balance sheet hits. In many cases, bank debt trades by appointment only.

According to these managers, though current opportunities are limited, the outlook is good. Refinancing, restructuring and bankruptcy opportunities are slowly appearing throughout Europe with the potential for a repeat of the 2009 U.S. credit markets. They expect to see these opportunities pick-up as banks are forced to deleverage and begin marking assets to market. Debt maturities are on a similar schedule as the U.S. with the majority occurring between 2012 and 2015, but many companies will begin the process sooner.

Market fragmentation throughout the European Union is expected to be a source of opportunities as a result of consolidation as well as decreased competition due to the complexity of investing across nations and legal jurisdictions. Europe has a significantly larger number of companies making up industries when compared with the U.S. A few examples are telephone companies and automakers. Europe has 15 large telephone companies and 10 automakers while the U.S. has five and two, respectively. Though the U.S. has not seen significant M&A activity during the last year, Europe has seen less. Imbalances don't last long as companies feel increasing pressure as they watch competitors actively pursuing and acquiring targets. In both markets, activity is expected to increase as short- and medium-term growth prospects are flat to negative. In order to grow they will need to do so through acquisition. One of the primary hurdles for merger activity in Europe is politics. Germany and France are known to be two of the most difficult countries for acquisitions. The German government attempts to estimate the impact of any transaction on their local economy which has slowed and in some cases stopped banner deals from being completed. France is the most interventionist of all the countries in Europe when it comes to stopping foreign takeovers, but they have also engineered inter-country mergers to create strong national companies. Even with political hurdles, the inefficiencies make opportunities attractive and deals will likely get done given the desire to find a source of growth.

OINK, OINK…WHAT ABOUT THE PIIGS?

Greek concerns and the potential for a sovereign debt default was a hot topic during our visit and just about every manager we met with weighed in. Below are some of the comments on the topic of Greece and the other countries that constitute the PIIGS.

Greece, Portugal and Ireland, combined, represent roughly 2% to 3% of European Union GDP whereas Italy and Spain each account for roughly 10%. Saving Spain and Italy will require enormous amounts of money. German banks own $500 billion of sovereign bonds issued by those countries, so it's in their interest to help them avoid defaults otherwise their own balance sheets will be impacted. Even with support, the PIIGS have significant fundamental problems which will remain. Expectation is the problems will get worked out, but it will be turbulent. Contagion is the greatest concern in the event of a default. Since all the banking systems are interlocked, the potential for spillover is high. Spain is the big concern as they have an economy dependent on tourism, significant real estate bubble and unemployment

is approaching 20%. The fact that the European Union is a currency union and not a political one makes this situation extremely difficult as there is no ability to impart decisions on others.

CONCLUDING REMARKS

While talk of sovereign debt issues in Europe continues to make headlines and the issues are expected to impact markets for some time to come, for the most part, managers see opportunity in the dislocation. Long-only and long-short equity managers are optimistic about the current opportunity set regardless of where they call home. Multi-strategy managers were the most interesting to speak with as their broad reaching knowledge of legal, accounting and political practices allows them to invest across countries and jurisdictions. There is a great deal of excitement about the expected opportunities over the next few years in the credit space.

We had an interesting trip and found the insight extremely helpful, validating most of our current themes.

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