

OnTarget Newsletter – July 2007

Can you prepare for a “CFD ambush” by an activist? Where can you take your REIT investment story in today’s negative headline climate? These issues and more in July’s issue of OnTarget.

OnTarget — Best Practices

Contracts for Difference – UK Activists Behaving Badly

Surprise is always the favored form of attack, and no one was more surprised than the board of the UK-based military manufacturer, Alvis Plc, when they woke one morning to find that aerospace giant BAE Systems had, along with a group of activist investors using Contracts For Difference (CFDs), acquired a near 30% stake in the company while not holding a single share between them. Alvis shareholders cried foul, but it was all perfectly legal, as stake-building using CFDs does not require the same level of disclosure as shares bought through the market in the conventional manner.

Since the morning of that dawn raid, UK regulators have put equity derivatives known as CFDs under the microscope. CFDs are synthetic instruments that offer investors direct exposure to a company’s share price, without the need to buy the stock itself. The payout is referenced to the stock’s price movement during the contract’s life, minus a fee of around 25 basis points.

Regulatory scrutiny comes amid concerns that CFDs are being used to secretly accumulate large stakes in companies, as a result of agreements between dealers and CFD investors. These agreements involve the dealer agreeing to sell the shares it has purchased to hedge its exposure from the sale of the CFD to the investor once the contract expires – and that, says critics, offers investors a back door to taking over a company.

In fact, some regulators have already decided to take action. Last year, the UK’s Panel on Takeovers and Mergers changed its rules, citing the Alvis takeover as one of its case studies. Now, investors with exposure to more than 1% of a company’s stock specifically during a takeover period – through shares or derivatives – must declare their interest.

So, can IROs now sleep safely in their beds knowing that the Alvis situation could not happen to their company? Err, no, unfortunately not. The Financial Services Authority (FSA), the UK regulatory body, has yet to address the protests from “long only” cash investors who are still concerned about shareholder visibility and the fact that anyone acquiring an interest in shares through CFDs is still not subject to the same disclosure requirements as those of the traditional investor, where they are required to disclose all shareholdings above 3%.

The London Stock Exchange estimates that CFDs now account for 20% of the daily trading volumes on the London market. In turn, it is estimated that in every FTSE 100 company, at least 15% of Issued Share Capital is held through holders of CFDs and, thus, the underlying holders enjoy anonymity and remain invisible on the company’s share register. If this situation is not worrying to the FSA, then it certainly is for companies and their existing long-term shareholders who, because CFDs are not disclosed, are not fully aware of the demand for the company’s stock.

Later this month, the Financial Services Authority (FSA) will announce the result of its own consultation on CFDs, launched in March as part of new rules linked to the EU’s Transparency Directive. No one should hold their breath in anticipation of a change in the regulations, however. Similar legislation in the Swiss Parliament adding required disclosure of ownership by derivatives is scheduled to be voted on in the summer session, but it may take quite some time for other countries’ regulations to catch up with a fast-moving financial system.

So, until these loopholes are addressed, if you leave the office at the end of the day feeling satisfied that you know your shareholder base, you may still be in for a surprise the next morning, just as companies like Carphone Warehouse, Prudential, and ABN AMRO were, when notified suddenly of an activist shareholder holding a large chunk of their stock accumulated through a CFD position.

By Mike Connard

Mike Connard is a vice president in CapitalBridge’s global market intelligence group, focusing on UK-based corporate issuer clients. He can be reached at mike.connard@cap-bridge.com.

REIT Investing – Weathering the Storm

It's been a difficult year for US REITs. The MSCI US REIT Index (including the much-maligned mortgage REIT category) dropped 8.1% for the first half of 2007, and just 18 of the 100 largest US REITs saw any positive price performance over that period.

The job of communicating with institutional investors is arguably even more important at a REIT than at a similar-sized equity in another industry. US REITs are on average more widely held by institutions than other equities in general. A cap-weighted sample of NYSE- and NASDAQ-listed REITs shows an average 85.6% of shares institutionally held, compared with the S&P 1500 weighted average of 74.0% institutionally held. Lower liquidity relative to other investments often hurts REITs competing for investment dollars with non-REITs (and may scare off wider sell-side coverage seeking higher liquidity for greater commissions). During the slowing of the residential real estate market and the mortgage crunch early in 2007, however, REITs have seen just as much volatility in their share prices overall, as investors fearful of exposure to a potentially weakening market sold off their holdings. This, of course, makes it even tougher on the REIT IRO, who faces daily reminders of all of the headlines concerning the US real estate market, all the while dealing with the specter of private equity firms snapping up consistent cash-flow-generating REITs like Vornado Realty (VNO) no matter what their size.

The good news is that investors beyond just the traditional "REIT shops" (RREEF, Cohen & Steers, etc.) are in the midst of a longer-term trend towards taking more stakes in REITs for the income components of their portfolios as well as for lower correlations with the rest of their equity returns, even despite the tough short-term outlook. This presents a fairly unique opportunity for the REIT IRO to break new ground in attracting both income investors and value investors to their story. Several types of potential investors come to mind as worthy targets for outreach.

First are income-oriented managers seeking higher current income for pension portfolios and other investments facing the demographic "time bomb" that is impending baby boomer retirements. While it's impossible to see the exact holdings of individual pension portfolios and ascertain their current income needs, those investors with the largest non-mutual fund portfolios and significant REIT positions are a good start.

Firm	Total Mgd Eq (\$M)	Non-MF Eq (includes pensions) (\$M)	REIT Holdings (\$M)	% of portfolio in REITs	# of REIT positions
Goldman Sachs Asset Management	144,064.4	106,405.6	5,314.2	3.7	91
Neuberger Berman	76,632.8	48,998.8	4,522.6	5.9	98
JPMorgan Investment Management	86,091.6	41,991.7	4,589.2	5.3	103
FAF Advisors, Inc.	37,741.1	25,941.3	1,416.3	3.8	138
Delaware Investment Advisers	35,585.8	19,191.9	1,954.0	5.5	75

Second are traditional value investors looking for an income component for their portfolio, especially those just starting to look at REITs. Even if a buy-side firm has never invested in real estate equities, don't consider lack of current coverage to be an obstacle – bylaws rarely prevent equity investors from looking at REITs, and even many generalist shops without a REIT-specific analyst will evaluate a REIT versus other equities based on risk/reward potential and valuation. Keep in mind that sell-siders covering REITs may not have close relationships with generalists – you may have to break new ground yourself.

Firm	Investment Style	Managed Equities (\$M)	New REIT Positions	New REIT Positions (\$M)	# of overall REIT positions
DWS Growth & Income Fund	Growth & Income	4,626.6	12	87.8	108
Fidelity Value Fund	Value	22,158.2	3	81.5	50
Fidelity Independence Fund	Growth	5,147.9	3	69.6	45
RS Partners Fund	Value	2,525.6	4	58.8	10
Vanguard Strategic Equity Fund	Growth & Income	8,184.1	6	41.9	103

You won't find many of these investors at your real estate investment conferences, but their investment dollars are just as green as a REIT shop's, and with a little extra effort you can produce a more diverse shareholder base that will help lower your volatility in the long run.

By Brian C. Matt, CFA

Brian C. Matt, CFA, is a vice president and head of CapitalBridge's institutional targeting group. He has previously written on convertible debt targeting in the April 2007 issue of OTN. He can be reached at brian.matt@cap-bridge.com.

OnTarget — Firms

Target Firm: Marsico Capital Management, LLC

Targeting Profile

The firm is a global investor in the large- to giant-cap growth-oriented equity space. It looks for securities with solid fundamentals, consistent predictable earnings, and effective management teams. While the firm's assets are only marginally allocated to global securities, the investor nonetheless presents an opportunity for companies based in Latin America and Continental Europe. While Denver does not present the same top tier capital as Boston or New York, you may look to package up a visit to the "Mile High City" with other local players like Denver Investment Management and Janus Capital Management to fill up a good day of meetings with strong purchasing power.

How to Approach

Of particular note, the firm's largest fund exposure lies in the Columbia Marsico Growth Fund, which is managed by Thomas Marsico. Expect the firm to dig deeply into its favorite sectors (currently financials, consumer discretionary, and information technology) while diversifying to manage risk across various countries and companies. The investor has a propensity to keep its sector weightings in motion, with its current favorites being the ordinary shares of Cisco Systems Inc. and Comcast Corp.

Average equity holding period: 2.5 years

How Not to Approach

If you're not at least moderately leveraged, you'll probably fall outside this investor's profile (51% debt/capital across the full portfolio). Moreover, it prefers a strong franchise, global orientation, and strong future cash flow, so if you fall outside these parameters, you might think about taking a pass.

Largest Portfolios Managed

Columbia Marsico Growth Fund
Marsico Focus Fund

Investment Potential

Average holdings for the firm at each market cap range:

Giant-cap: ~\$565 million
Large-cap: ~\$391 million
Mid-cap: ~\$115 million
Small-cap: ~\$28 million

OnTarget — Funds

Target Fund: Fidelity Low-Priced Stock

Managing Firm

Fidelity Investments, Joel C. Tillinghast (617 563 6427, joel.tillinghast@fmr.com)

Targeting Profile

If you are an undervalued, small-to mid-cap company looking for hefty purchasing power in the Boston area with a low turnover then this is your fund. The fund's objective has changed over time and its average market cap is rising, accomplished by expanding the list of companies eligible for purchase. The fund's exposure to micro-cap stocks fell from 35% in 2000 to 8% currently, meaning mid caps have more opportunities for value. It is a known "buy-and-hold" fund over the last quarter, as evidenced by 523 of its 733 positions seeing "no change" for the period.

How to Approach

A diligent bottom-up stock picker, Tillinghast pays little attention to market indices or macroeconomic trends. Rather, he tries to find low-priced stocks of companies that can grow their earnings even in an adverse economic environment. The manager dedicates the fund's initial stock-picking criteria to his 80% policy (80% of his stock picks have a stock price below \$35). The fund has a value-oriented investment selection, but seems to range between "growth" and "value" stocks. Also, with an increasingly global exposure, make sure to highlight your international growth opportunities as part of your communications strategy.

How Not to Approach

The fund over the years has been dedicated to small companies, so if you are a large- or mega-cap company, it's highly unlikely you'll catch Tillinghast's attention. Additionally, utility and telecommunication stocks are two industries not heavily invested in the fund. The fund looks for companies that have a competitive edge and greater predictability in the form of recurring revenues. Currently, the fund has \$40 billion under assets and remains one of the largest small-blends or mid-blends around. The high average equity holding period is evidence that the manager does not pull the trigger unless he finds the right low-priced growth company with substantial capital appreciation potential. Fidelity has closed the fund to new investors, which is good evidence of the pace at which the fund is growing.

Investment Potential

Average holdings for the firm at each market cap range:

Mid-cap: ~\$16.4 million
Small-cap: ~\$10.2 million
Large-cap: ~\$4.7 million
Giant-cap: ~\$2.8 million
Micro-cap: ~\$1.2 million

Average equity holding period: 5.8 years

OnTarget — Contacts

Recent notable contact moves:

Anne-Merieka Ezendam (Director and Portfolio Manager) joined Credit Suisse Asset Management Ltd. in June 2007, covering the healthcare sector. She was formerly the head of healthcare, portfolio manager and an equity analyst at Threadneedle Asset Management Ltd.

Glenn Shapiro (Equity Analyst) joined Balyasny Asset Management, LLC (BAM) in May 2007, covering the financial sector. He was formerly a security analyst at Sigma Capital Management, LLC.

Michael Bradshaw (Portfolio Manager) at Evergreen Investment Management Company, LLC was promoted to his current position in June 2007 to manage the Evergreen Precious Metals Fund. He was formerly a senior equity analyst covering metals and mining at the firm.

David Shaw (Equity Analyst) joined Legal & General Investment Management Ltd. in April 2007, as a member of the European active equity team. He was formerly an equity analyst at BlackRock Investment Management Ltd.

Albert Savastano (Research Analyst) joined Fox-Pitt, Kelton, Inc. in June 2007, covering the banking and thrifts industries. He was formerly a research analyst at Janney Montgomery Scott, LLC.

To keep an eye on other major contact moves, subscribe to CapitalBridge's IRxtras monthly newsletter containing research updates on movements from contacts, firms, and funds. There is no charge for this newsletter. To subscribe, simply email IRxHelp@cap-bridge.com.

OnTarget — Conferences

Vacation time! Holidays and earnings season occupy most of this month's calendar.

Conferences – July 2007

Mon	Tues	Wed	Thurs	Fri
2	3	4	5	6
9	10 CIBC World Markets 7 th Annual Consumer Growth Conference – Boston CE Unterberg, Towbin Growth Opportunities Conference – NYC	11	12 CIBC World Markets Lodging, Gaming & Leisure Conference – Boston	13
16 Friedland Capital Summer Global Equities Conference – Atlantic City	17 SEMI SemiconWest Conference 2007 – San Francisco JPMorgan SemiconWest Investor Mini-Conference – San Francisco	18 AG Edwards Exploration & Production Conference – NYC	19	20
23	24	25	26	27
30 Merrill Lynch Emerging Europe, Middle East & Africa Mid Cap Conference – London & NYC	31 Keefe, Bruyette & Woods 8 th Annual Community Bank Investor Conference – NYC			

This calendar shows a sampling of investment community events held around the world during the month. Source: FactSet CallStreet, LLC

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