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Alternative View of Emerging Markets in Newport Center

FINANCE: Finds Hugo Chávez more than reasonable

By JANE YU

Newport Center isn't as far from emerging markets as it seems.

Not for **SW Asset Management LLC,** which keeps offices in the swank business center and specializes in corporate bonds issued by companies in far-off locales ranging from Nigeria to Kazakhstan.

Hinman, Zucaro: brought Venezuelan experience from Drake Capital in New York to Newport Beach

Government bonds are typically considered one of the safest forms of investment. Corporate bonds generally carry more risk—and they're perceived as riskier still in emerging markets.

SW takes a different view.

"In the credit markets of the U.S. and Western Europe, numerous managers specialize in corporate debt management, but very few managers focus specif-

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ically on emerging market corporate debt," Managing Principal David Hinman said. "This market is underrepresented."

SW recently reaped profits in Venezuela, thanks in part to President Hugo Chávez, who bills himself as anything but a capitalist in running the South American nation.

Legal protections that apply to foreign corporate bonds also helped.

Profits rolled in when Chávez purchased the dollar-denominated bonds of **FertiNitro**, the country's largest fertilizer company. FertiNitro previously was owned by **Pequiven** in Venezuela and Wichita, Kan.-based **Koch Industries Inc.**

Chávez nationalized the company in late 2010. Venezuela's government offered to buy back FertiNitro bonds two months ago for $1.05 on the dollar. That's 54% above their trading price before nationalization.

Chávez: Venezuelan leftist observed rule of law on bonds after nationalizations

"FertiNitro is a good example of how U.S. law protects bondholders of emerging market corporate bonds," Hinman said. "There is a 'change of control' provision in the bondholder indenture that requires the new buyer—the Venezuelan government, in this case—to take out the bonds at a premium. We worked through the process and received the return."

Bondholders sometimes get less protection in the U.S., according to Hinman, who cited **General Motors Corp.**'s brief stay in the federal government's portfolio as an example.

"Unions benefited, and salaries were protected, but equity holders were wiped out," Hinman said. "Bondholders were getting 30 cents on the dollar."

SW was launched in 2009 by partners who saw the emerging market corporate bond market as relatively untapped.

"The investor community has gotten more comfortable in emerging market commodities," Hinman said. "But that hasn't necessarily mapped over to corporate bonds, where investor protection is similar, but yields are much higher."

With higher yields come higher risks.

"Emerging market corporate debt significantly increases the risk profile for an investor," said Jay Ferrara, vice president and investment officer at Long Beach-based **Farmers and Merchants Trust Co.**'s office in Laguna Hills. "Financial statement integrity, regulatory framework, currency movements—all of these items must be considered in this type of an investment in addition to the targeted company's prospects."

SW's Hinman sees that sort of caution working in favor of bondholders in some ways.

"The fear that investors might not have legal rights ... the fear that equity owners might undertake actions to the detriment of the bondholder—those risks are one reason that the indenture is written favorably for bondholders."

The emerging market corporate bonds market has grown over the last decade from about $50 billion outstanding to $800 billion, Hinman estimated. SW holds about $260 million in emerging market corporate debt.

Orange County is home to a number of firms that invest in emerging markets.

"The two big ones would be Pimco and PacLife," Hinman said. "The smaller base would be Armored Wolf—we see that as competition."

Newport Beach-based **Pacific Life Insurance Co.** has about $116 billion in assets. **Armored Wolf LLC** is much smaller and based in Aliso Viejo.

SW is a four-man team composed of two managing principals and two directors.

Prior Experience

Hinman's prior stints include most recently managing $5 billion in credit assets at New York-based **Drake Capital Management LLC** and overseeing credit portfolios at Los Angeles-based **Ares Management LLC.** He also spent 10 years at Newport Beach-based **Pacific Investment Management Company LLC**, which manages $1.3 trillion.

The other principal, Raymond Zucaro, was most recently at Drake, overseeing emerging markets portfolios.

Chief Finance Officer Robert Venable also is a Pimco veteran.

Santiago Cuneo is an Argentina-educated economist who arrived at SW after serving as a portfolio manager at **StratEdge Investment Advisers LLC** in Miami.

The SW team is focused on Venezuela, Argentina, Nigeria and Kazakhstan these days.

The Venezuelan government is no stranger to nationalizing companies—and the FertiNitro bonds weren't the first time SW's executives found opportunity there.

Hinman and Zucaro managed gains at Drake, when bonds the firm held in **Petrozuata Finance Inc.** were repurchased.

Petrozuata was nationalized in 2007, and the Venezuelan government bought back its bonds a year later in a process similar to the FertiNitro deal.

"We used the same law firm, and it was the same indenture language that was used in FertiNitro," Hinman said. "The takeout was roughly 10% higher than par."

Nationalization of a company is one of the "events" that SW sees as opportunities for profitable returns.

"We focus on the event-driven trades," Hinman said.

Those also can include covenant violations, significant regulatory changes and asset spin-offs.

"The interplay between the private sector and the government can have a large impact on how bondholders fare," he said. "And often times, the governments are controlled by a few families in an emerging market country, such as Indonesia and Kazakhstan."

Other countries that have become popular with many investors don't measure up to SW's risk-reward gauge.

"We don't like Brazil or China," Hinman said. "Brazil is the closest emerging market country to the developed market, and we don't feel the yields in Brazil properly compensate that they are half-emerging market and half-developed market. And we're concerned about the banking system in China." ■