

The Hedgeweek Interview: Steven Solmonson, President, Park Place Capital Limited: "We are not market timers and we are not punters"

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Steven Solmonson explains how Park Place delivers through its strategy of remaining long-biased, moderating exposures and ongoing diversification.

Steven Solmonson served as a non-executive advisory director of Park Place from 1994 to 1999. In January 2000, he joined the firm and is responsible for the firm's business operations, including risk management and portfolio reporting, client services, business development and operations. Previously, Steven was the President of Value Investing Partners Inc. (1995-1999) and earlier, he was a Managing Director at Lehman Brothers, Smith Barney and Drexel Burnham Lambert. As co-director of the futures and derivatives division at Drexel, Steven was responsible for risk management, business development, international sales and trading and fund products. He served as a director of DBL's Winchester Fund of Funds as well as DBL in-house Hedge Fund Advisory Corp. At Lehman, he managed the international branch offices, where he launched the Global Advisory Fund of Funds, and subsequently, served as a director of the Edgehill Select Umbrella Fund. He currently serves on the board of directors of AlphaVax Corp, a biotech company. Steven received a BA from Columbia College in New York and completed a postgraduate program at the London School of Economics. He received a JD from Brooklyn Law School and was admitted to the Bar of New York in 1980.

HW: What is the background to the fund?

SS: Park Place Capital Ltd manages two Long/Short European equity funds: Park Place Europe, our flagship fund that was launched in 1994 and Polaris Prime Europe, our specialty fund that was launched in 1997. Both funds are managed by the same team, headed by Jean Marc Fraysse & Peter Schell, and both funds draw upon the same research driven investment process. Yet - they differ from one another with respect to the portfolio weightings, diversification and exposures. Many of our investors are invested in both funds - creating a blend. Park Place Europe's current AUM is approximately USD 250 million and Polaris Prime Europe's current AUM is approximately USD 200 million.

HW: Who are your service providers?

SS: Both funds are structured as Master-Feeder funds, with an onshore feeder for US investors and an offshore feeder for Non-US and US tax-exempt investors.

Morgan Stanley is the prime broker, Bisys is the administrator and PriceWaterhouse is the auditor. Park Place Europe uses the law firm of Katten Mutchin and Polaris uses Seward & Kissel.

HW: How and where do you distribute the fund? What is your current and targeted client base?

SS: Our investors are fairly diverse; including European, US as well as Asian & Latin American investors. But for friends & family, our investors are institutional, including global and boutique fund-of-funds, consultants, and professional family offices. We provide detailed reporting in an effort to be sure our investors understand what we are doing and how we do it. Our investors are our partners - we have a great mix of investors. We especially appeal to investors who have taken the time to learn about the changes we made at the firm in late 2002 when Jean Marc and Peter joined the firm. We continue to expand our client base - especially aiming to reach investors who recognize that small funds have an advantage and those who don't simply crunch sharpe ratios.

HW: What is the investment process of your fund? HW: How do you generate ideas for your fund?

SS: The first step is a screening process where the managers run four sets of screens on the universe. In all cases, we screen for change. These screens are: a) Price Momentum (3 months and 12 months, absolute and relative); b) CFROI; c) Implied Growth, and d) Earnings Revisions. These screening mechanisms are provided to us by a variety of suppliers. CFROI by Collins Stewart Ltd, Earnings Revisions and Implied Growth by CSFB and Pereire Todd, while Price Momentum screening is done on a proprietary system. The output of these four parallel screens is referred to as our Action List.

SECTOR OVERLAY: The Action List is culled by performing a macro screening and sector overlay. The sub-sectors of the FTSE Europe are passed through the same four screens to focus attention on those sector aggregates evidencing the most significant change. The team also develops a view on the business cycle while incorporating the recent macro catalysts as well as the yield curve and the direction of interest rates. This allows the managers to look at the action list critically and focus on those areas where change will create the biggest opportunities. The team does not explicitly make macro-economic forecasts but uses the output of its screen and the interpretation of economic data to develop and repeatedly test themes and assumptions.

BOTTOM-UP: Potentially interesting investment opportunities that have been identified on the Action List (per the above top down process) are then vetted by the research team in order to identify the most promising candidates for inclusion in the portfolio. Here too, we apply multiple steps. We examine the 'business drivers', focusing on the company's competitive position within its industry and the value creation characteristics of its sector. These are determinants of pricing power and - combined with analysis of volumes - ultimately of cash creation. We are especially interested in companies, which demonstrate QVS (Quality, Visibility &

Sustainability) of cash flow. This will give us insight on the extent, nature and possible duration of the change. The business is also analyzed at the balance sheet level to assess its capital intensiveness, the way assets are financed and the need for working capital.

Special attention is given to company visits. The management team conducts an average of 250 company visits a year, mostly on a 1 on 1 basis. These meetings not only provide valuable insights into a company's business strategy, plans for the future and ability to communicate, but also provide critical feedback into the team's macro views. A company's assessment of the environment in which it operates materially enhances the team's ability to think laterally and forecast company earnings and likely developments in the business cycle, as well as to systematically test the robustness of their sector views. This in turn plays a significant role in portfolio construction.

HW: What is your approach to managing risk?

SS: Risk management is a critical and on-going part of the investment process. First and foremost, risk management begins with ensuring that the qualitative stock selection process is comprehensive. In addition, we employ alarms when any holding moves 10% move from its average cost or 10% from its highest mark. In either case - a full review and reassessment is required. In addition, any holding that generates a -1% impact on NAV is almost always liquidated. Diversification and Liquidity Guidelines are supplemented by daily review of VaR and Beta Reporting. The volatility of all holdings in the portfolio are ranked and reviewed on a regular basis in order to better identify the components underlying the portfolio VaR. Our front office system provides all of us a live-market view of alpha on the long and short books, and also shows the top and bottom 15 holding ranked by both size and attribution. We always watch the portfolio exposure and attribution in terms of 1) industry, 2) market cap and 3) country breakdown. While we are prepared to tolerate measured volatility, we are very mindful of the risks vs. rewards.

HW: How/against what do you benchmark the performance of your fund?

SS: We always report our performance side-by-side with The MSCI Europe Local Currency Index. Yet, while we are mindful of relative performance, at days end, what counts is absolute performance in both bull and bear market conditions.

HW: Has your performance been as per budget and expectations? Do you expect your performance or style to change going forward?

SS: Park Place Europe targets 10 to 20% annualized returns and Polaris Prime Europe targets 15 to 20% annualized returns. While we have outperformed in recent years - we remain focused and humble. We have a rigorous investment process, which is responsive to variable market conditions. We routinely monitor market momentum and market volatility as well as the portfolio's beta and diversification. These four factors are critical with respect to determining our exposure levels. We are not market timers and we are not punters. We have a view on the market and we are directional - not market neutral. We do our homework

and look to find promising investments in multiple industries and a broad mix of companies. While we routinely self-examine and occasionally make enhancements to sharpen our tools, we have every intention to remain focused on what we do best for the long-haul.

HW: What opportunities are you looking at right now? What events do you expect to see in your sector in the year ahead?

SS: The reporting cycle for 2005 has proven strong, Euroland earnings revisions have continued upwards and US revisions have ceased to decline and are now stabilizing. Attractive valuations are containing downside risk while M&A activity continues to provide support. Rates are going up, but in a predictable fashion and oil, unlike last year is trading in an equally predictable trading range. After all, one must not fall into the trap of believing that a flattening yield curve implies imminent slower growth. A steepening yield curve is good news for equities but a flattening curve isn't always bad news.

We continue to believe that risk is increasing. We find that price momentum remains confined to the same sectors. These revolve around commodities, the heavy end of the investment cycle, oil services and utilities, specifically those exposed to carbon credits and electricity generation. On the negative side, food, beverages, food retail, media, pharmaceuticals and telcos remain unloved and the privy of short sellers. Worryingly, the former group is now coming through as expensive on our value screen while the latter are coming through as cheap. It is hardly a stretch to forecast a rotation but the timing, as always, remains elusive. There is a sense that the upcoming peak in the US rate cycle, whenever that may be, may spell the end of the commodity cycle and with it the end of the 'growth through globalization' theme and engineer this rotation. No wonder everybody is trying to second guess Chairman Bernanke.

Now that we have presented both sides, where do we stand? We remain resolutely if cautiously net long, and for a number of reasons. First, valuations continue to be attractive both on an absolute and relative basis. Secondly, companies continue to have good earnings momentum, even in a context of peaking ROE and EBIT margins. Seldom have company managements visiting our offices been so universally bullish. Finally, the drivers of European recovery are continuing to unfold. Forced restructuring remains the order of the day throughout industrial Europe. The current French farce will probably play out into a political draw, but the reforms will no doubt go through. The current rate structure incentivises European consumers to spend and not to save. Good jobs figure will further fuel consumption growth. Thirdly, the markets have good price momentum, liquidity and corporate activity and it remains foolish to go short such momentum. Better to stay the course but with a wary eye. Finally and most importantly, there remains upside to the price targets of the positions in our portfolio. Stock picking and hard work remain now, more than ever, the order of the day. We continue to see H2 2006 as harder to call than H1 but expect our process to help us to continue to deliver attractive returns for the fund's shareholders.

HW: How will these changes/future events impact on your own portfolio?

SS: While we currently remain long-biased, we've already moderated our exposures and broadened our diversification. Although the current environment has been difficult for outright shorts, we're adding more and more potential shorts to our active watch list. At the same time, we're beginning to add names in consumer and media names to our potential long list.

HW: What differentiates you from other managers in your sector?

SS: We have a great team and we're all on the same page. We're not kids and we're not looking to make a quick return on single hot stock pick. As previously noted - our investment process is key to continuously renewing productivity and objectivity. Above all - we work hard and love what we do.

HW: Do you have any plans for similar/other product launches in the near future?

SS: Recently, we've closed Polaris to new subscription and we expect to close Park Place Europe later this year. We want to remain small and we imposed capacity limits on ourselves to ensure that these funds remain on track. We especially want to be sure we are nimble if and when the time comes for the portfolios to be aggressively short. That said - several investors have asked us to consider a dedicated Mid/Small Cap fund, while others have expressed interest in a long-only product and/or a UK-only long/short product. All are possibilities - but we'll need to schedule a follow-up interview to address the outcome.

(Steve Solmonson was interviewed on 8 May 2006; the interview was revised on 30 May 2006)

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