

Emerging Europe Convergence

Starting with the premise that Eastern Europe will continue to display faster growth rates than Western Europe in the convergence process, the Metzler/Payden European Emerging Markets Fund is set to benefit from this trend. While the fund manager, Markus Brück, believes that the greatest opportunities and efforts should be in the small-cap area, he also doesn't ignore large caps in order to build a stable, diversified, and less risky portfolio.

Q: What is your investment philosophy?

A: The core investment philosophy is that Eastern European countries will converge sooner or later with the living standards in the developed European markets. Because of subsidies and the good conditions in those markets, such as low taxes and wages, we expect GDP growth rates to remain higher than in Western Europe for the next decade or two. If GDP growth rates are higher, companies should generate better earnings and these markets should outperform the developed markets in Western Europe. It's a relatively straightforward philosophy based on our belief that such a product has a bright future.

Q: Why do you think that Eastern European economies will manage to sustain higher growth rates?

A: If you believe in the globalization theory, according to which capital is looking for the best profit-generating conditions, you should also believe in higher GDP growth rates for the region. There are huge gaps between wages and taxes in Eastern and Western Europe, so you may argue that Western economies will have to cut their taxes. But since we are living on a higher "welfare level," there is no chance for us to become as competitive as Eastern Europe. I believe that what will happen is a gradual improvement of the laws, systems and institution rules in Eastern Europe, which will make foreign direct invest-

ment less risky. We'll see sustainable real wage growth in the next decade but that's not a competitive issue because of the current low productivity levels. They can easily raise productivity and achieve real wage growth without losing their competitiveness against Western Europe.

We should also account for the massive subsidies some of these countries will get from the EU in the period from 2007 to 2013. For example, Romania and Bulgaria will receive between 25 and 30 billion euro during that period. That is a massive input and an additional factor to support growth. Yes, the money will be used mainly for infrastructure, but it will lead to a higher growth rate in the region.

Q: Which emerging markets do you look at?

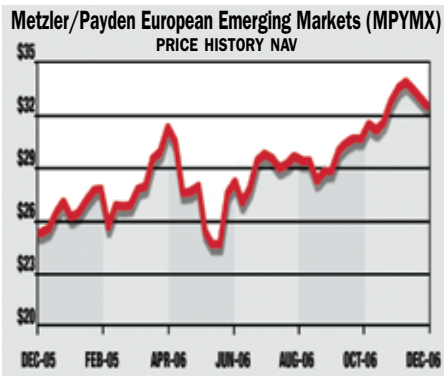
A: We invest in Eastern Europe, which includes the countries that already joined the EU plus the next wave of candidates. It includes Romania and Bulgaria, which are joining the EU now, and Croatia, which may become a member in 2009. We are looking also at Serbia and Bosnia. Russia is also a part of our investment universe. The country is not EU candidate, of course, but it should have its place in the fund due to the great prospects for the Russian economy. The Russian market has significantly contributed to the fund's performance in the last four years and it



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Markus Brück holds a degree in economics from the Justus Liebig University of Gießen/Germany.

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is an important market for us. It has performed exceptionally well in a competitive area and has outperformed all the Western European markets.

I should add Ukraine to this list, and several smaller countries, former USSR republics with oil-oriented economies. There are, however, limited opportunities in these countries, mainly in the oil companies, and we are looking for international listings because the local equity markets are not developed enough.

Q: What's your strategy for selecting companies?

A: Our investment process is a mixture of three main pillars - a top-down strategy, which determines the country weighting, a bottom-up approach for selecting the more liquid companies or large-cap stocks, and a strategy for picking smaller companies with market capitalizations of several hundred million euro.

The top-down approach is really important because these countries have completely different political developments, convergence paces, and fiscal situations, which means that you have to assume different risks for those markets. There are countries meeting most of the criteria and there are countries with problems to adapt. A bank in Poland may not be trading at the same price-to-earnings ratio as a comparative bank in Hungary because of Hungary's current fiscal and structural problems, which lead to different risk premiums for the country, including single stocks. That's why we believe that we should consistently follow the macro environment and make our decisions on coun-

try weightings from a top-down perspective.

The second part is picking more liquid companies with a market cap between \$1 billion and \$200 billion. There are four major sectors that you can find in every emerging market, maybe with the exception of Turkey, which are banks, telecoms, utilities, and oil. We believe that the hidden value in excessive direct research on those larger companies is lower than for smaller caps, so we rely on quantitative pre-screening in the first phase of the process using different parameters on valuation and momentum.

We divide the sectors into 'attractive', 'neutral', and 'unattractive' and focus our efforts on the 'attractive' area. For example, in the qualitative part of the selection process, after we have identified 10 'attractive' telecom companies, we talk to analysts and discuss the assumptions behind their models, what they believe regarding the growth rate, margins, etc. Then we decide how to position ourselves. We believe that running our own models on large, well-covered companies is a waste of time. Instead, we have critical discussions about the market, the assumptions of mainstream analysts, and correlate that to what the management is thinking.

The third part of our strategy, smaller companies, includes a broad list of several hundred companies with a market cap of between 100 to 300 million euro, or even lower in certain cases. Analyst coverage for these companies is very sparse, sometimes non-existent. That's where we have a higher probability of finding companies with hidden value that are neglected by the market, but may become the focus of investors if they grow larger and more successful.

Q: Can you give us an example of how that strategy works?

A: If you look at Romania and its skill set, you'll arrive at the conclusion that the people are very well educated in mechanical and electrical engineering. Just by traveling to meet companies,

you'll witness the available skills in that area. This could be the first step to focus on companies in that business and that's how we built such an exposure in Romania. We have a couple of companies in the aerospace industry, and a company in the automobile industry.

An important feature of that third pillar is that every fund manager not only has the responsibility for his product, but also for a sector in our Western European core products. That gives the manager a way to discern and crosscheck opportunities. It is part of our philosophy that people should not be confined to the product they manage but should also have a footprint in the core products in Western Europe.

Another example of idea generation is how three years ago, while oil prices were going through the roof, it came to our attention that China and Kazakhstan were negotiating to build a pipeline between the two countries. This was the trigger to start checking the listed oil-producing companies in Kazakhstan, which wasn't an easy job as there was less than a handful listed on international markets. But we managed to find such companies and one of them, Petro Kazakhstan, traded at a price/earnings ratio of 3.5 at the time. We thought that once the pipeline was ready, it would be like a high-speed train connection from a large city to an outside area that makes property prices go through the roof. We anticipated this to happen with the Kazakhstan oil companies, and as the pipeline project comes closer to the end, the companies have started to rise and quadrupled their revenues. Petro Kazakhstan was bought by a Chinese state-owned company, which wasn't in our assumption, and isn't listed anymore.

Overall, I believe that to generate ideas you have to be really creative, read a lot, travel a lot, and see a lot. At the end of the day, everything can be a starting point to research a specific story.

Q: How do you handle the differences in accounting standards and the related risks?

A: That's an important point and a good question. If we have a really great story in the market and we definitely want to take a position, we may decide to invest in a basket of companies with smaller weightings to mitigate the risk of incompatible or incomplete financial statements. We normally look at the debt situation and cash flows for such companies. We know that there might be a risk for the companies in the countries that aren't close enough to Western European standards, so we create baskets in different industrial areas to reduce portfolio risk. If we identify eight companies in a sector, even if one or two of them go bankrupt, you can live with that because, at the other end, companies can quadruple or more with growth of 600% - 700%. We have companies that have closed due to bankruptcy, but that has not particularly hurt us because of the minimal exposure.

If we like a certain small-cap stock, even one with only a 100 million euro market cap, which reports according to local accounting standards, we would maintain extremely close contact with company management. That means frequent conference calls, visits, and "bugging" the management often.

Q: Do you find the management meetings in those countries useful?

A: Yes, and sometimes we have very interesting discussions where we almost act as unofficial consultants. For example, we own shares in a company which finances investments only with cash. We gave them a primer on the use of debt to provide opportunity for external growth. These conversations are very different from traditional management meetings, where you meet experienced people and it's hard to get any information. So we find the meetings with smaller companies extremely helpful for both sides. They are very rewarding as opposed to talking with the CEO of a major automobile manufacturer, for example, who has several hundred meetings a year and is "coached" by a professional investment relations department.


Q: How do you manage the fund in terms of portfolio construction?

A: We invest only in listed companies. Currently we have around 60 companies that trade in 10 or 11 markets. The bulk of the portfolio is in ADRs but in the less developed markets, you have no chance to find an ADR, so you have to look for listings in the local market.

Our portfolio structure is stable, not too risky, and doesn't ignore any large caps. That's why we research large stocks, but not with the same intensity as the smaller ones. We concentrate the bulk of our research efforts on small companies to discover them before the market does. They are an important part of our portfolio, representing about 20% to 25% of our ideas and positioning. Although each company is a small part of our portfolio, as a whole they contribute immensely to the fund's performance and diversification.

Q: What is your view on the specific risks in the region?

A: The major risks are mostly political. At the end of this convergence process, you have winners and losers in the population, which can lead to a radical change in the political landscape. That doesn't mean that there will be riots on the streets, but there are risks for fiscal stability and monetary policy coming from the political side.

Nationalist parties that highlight the risks of convergence are becoming more popular in the region, as some have not benefited from the EU accession. That's something that I had not expected, at least not this early. On the other hand, young people are extremely optimistic. They believe that we are in a completely new decade and do not have the concerns of their parents. The political shift is the main risk at the moment, although it doesn't mean leaving the EU, but it may mean shifting the focus away from meeting EU requirements, and that will affect the markets. Right now, the outlook for GDP growth is quite bright, with the exception of Hungary, so market participants are neglecting political changes and uncertainties. 

Metzler/Payden European Emerging Markets

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Inception	12/30/02

PORTFOLIO

Total Net Assets*	\$257
Avg Mkt Cap (\$ Weighted)*	\$39,077
Average Price/Earnings Ratio	14.1
Average Price/Book Ratio	2.6
Turnover Ratio	150%

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$5,000
Min Subsequent Investment	\$1,000
Min Initial IRA Investment	\$2,000

RISK (MSCI EAFE ND INDEX - SINCE INCEPTION)

Alpha	10.55
Beta	1.71
R-Squared	60
Ann Std Deviation	20.8
Sharpe Ratio	1.78

RETURNS VS. MSCI EAFE ND INDEX

	MPYMX	Index
1 Year (Cum.)	46.33%	26.34%
3 Year (Ann.)	45.65%	19.93%
5 Year (Ann.)	N/A	14.98%

RETURNS VS. MSCI EM LATIN AMER INDEX

	MPYMX	Index
1 Year (Cum.)	46.33%	43.48%
3 Year (Ann.)	45.65%	44.44%
5 Year (Ann.)	N/A	32.33%

FEES AND EXPENSES

Max Sales Charge - Front	N/A
Max Sales Charge - Deferred	N/A
Max Redemption Fee**	2%
Total Expense Ratio	1.25%

PORTFOLIO MANAGER

Markus Brück	2002
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*millions **within 30 days of purchase

Data through: 12/31/06

Source: Company Documents; Lipper

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