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DJHFSB Daily Estimates (52 wk)*



DJHFSB Weekly Returns

Index	Value	Week (%)	YTD (%)	52-wk (%)
DJ Wilshire 5000	55.49	1.62	8.51	22.7
DJ Corp Bond Index	198.39	-0.9	1.49	6.78
Convertible Arbitrage	133.93	-0.13	1.89	7.21
Distressed Securities	187.15	0.51	6.25	15.53
Equity Market Neutral	110.96	-0.64	1.96	6.95
Event Driven	152.56	1.23	7.66	16.29
Merger Arbitrage	135.73	0.93	9.37	15.6
Equity Long/Short	125.69	1.32	9.79	15.97

As of 5/23/07

* Estimates normalized to reflect \$100 invested in each index at start of 52-week cycle.

The above listing of Dow Jones Hedge Fund Strategy Benchmarks (DJHFSB) components is current as of the date stipulated.

Source: DJHFSB

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After Divorce, KBR Finds Long-Term Partners In Hedge Funds

■ *There's a marked difference between the views that Wall Street and hedge funds take on the company. Funds like its cash flow, management and the new flexibility it will have now.*

BY MARA LEMOS STEIN

As the dust settles after KBR Inc.'s split from Halliburton Co., a few heavy-weight hedge funds stand out as investors in the engineering, construction and services company, suggesting there may be more to the trade than just an arbitrage play.

Around 25% of the stock is in the hands of hedge funds, and some of that ownership is a result of funds' playing in the exchange of Halliburton shares for KBR's, the last phase of the split-off

concluded last month. But the return of KBR as a stand-alone company after 44 years as a subsidiary of the oilfield services giant is an opportunity for investing in the hot energy sector through a company that is largely misunderstood by Wall Street analysts, said hedge fund managers and analysts who are focusing on the company's cash stash and cash flow rather than on earnings per share.

"KBR still trades at a huge discount to peers, it generates a lot of cash, it has

a balance sheet that is ridiculously over-capitalized," said one analyst at a West Coast hedge fund that is a holder of KBR stock. "We think this is a multiyear positive environment for global infrastructure construction, not something that will go away any time soon, and KBR will be able to build a solid margin and higher visibility business."

Hedge funds think KBR's stock is

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Will And Grace: Funds See Strength In Chemical Company

■ *Hit by a slew of asbestos claims several years ago, the chemical maker is in better shape than many other bankrupt companies. Longtime holders have made a sizable profit, but now bears are moving into the name.*

BY JOSEPH CHECKLER

Hedge funds are not distressed about W.R. Grace & Co.'s six-year bankruptcy. In fact, they're getting rich off it.

The stock of W.R. Grace, a Columbia-Md.-based maker of chemicals for building materials, has tripled since August 2006 and is now trading at more than \$25 per share. The beneficiaries are hedge funds - mostly distressed and special-situations shops - which have snatched up shares recently and correctly bet that W.R. Grace's lingering asbestos litigation problems wouldn't be as bad as first thought. Even amid the run-up, funds think recent courtroom victories and the strong state of the chemicals sector make the stock worth holding on to.

The company's prospects are looking better since a ruling late last year by Delaware bankruptcy court Judge Judith Fitzgerald, which said claimants would have to prove that their illnesses were caused by W.R. Grace's chemicals.

"In the past year, there's been a sea of change in the investment community's view [of the stock]," said the manager at a hedge fund that has held the stock for years. Hedge funds are seeing that "if people really fight, they can winnow down the actual claims in a big way."

Some hedge funds have been longtime shareholders of W.R. Grace, buying some of their stock when it first filed for bankruptcy and was trading at less than \$2. Those include Charlottesville, Va.-

based **Peninsula Capital Advisors** and Chicago-based **Citadel Investment L.P.** According to Securities and Exchange Commission filings and W.R. Grace's stock price history, Peninsula's 10.8 million-share stake was worth less than \$17 million in late 2001 and is now worth more than \$280 million.

"I think the stock only now is reflecting what's been happening in the courtroom"

A hedge fund analyst

But many of the hedge fund owners have bought in recently, going against their usual trading strategies. Distressed fund **Silver Point Capital** bought most of its shares in 2006 and has seen its 3.2 million-share stake double in value since September 2006, according to filings. Marc Lasry's distressed hedge fund, **Avenue Capital Management**, had held fewer than 600,000 shares of W.R. Grace since 2004 but bought more than 800,000 additional shares during the first quarter. Silver Point and Avenue declined to comment for this story. The purchasing of equities is a new phenomenon in distressed investing, going against the usual strategy of buying bonds of bankrupt companies in order to gain equity post-reorganization.

Of course, when the stock of a bankrupt company is trading above \$25, there are going to be bears. Sure enough, short interest in W.R. Grace's stock nearly doubled from March 15 to May 15, to 11 million of the company's 69.2 million shares. It is not known which hedge funds are shorting the stock, as investors are not required to report short positions.

"Bears are saying 'Things are going well as they possibly can, and the stock is starting to reflect some of the success they've had,'" said an analyst at a New York-based fund that bought W.R. Grace shares in 2006 and has seen its stake more than double in value since then.

Despite the increased short interest, fund owners think W.R. Grace still has potential, the analyst said. "I think the stock only now is reflecting what's been happening in the courtroom," he said. Still to come, the analyst said, is when the company starts to gain more traction selling its products, which include chemical additives to concrete products and sealing and closures for food and beverage containers.

The company filed for bankruptcy mostly so it could center all its asbestos claims in one place, U.S. bankruptcy court. Besides that, according to the manager at the long-time hedge fund

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Downey Seen As Mortgage Lender That Will Hold Up

■ *A bunch of funds bought the stock in the first quarter, betting on strength in the prime lending market. Massing short sellers take a less optimistic view of its outlook.*

BY JOSEPH CHECKLER

It might come as a surprise that a mortgage lender's stock had one of the largest positive changes in hedge fund popularity during the first quarter, but funds have recently been buying up shares of Downey Financial Corp.

For some, it looks to be a case of follow the leader, longtime top shareholder **Tontine Associates**. For others, buying Downey stock was a case of finding one of just a few bullish bets in a very bearish sector during the first quarter. And, not surprisingly, there's a short-selling contingent that thinks Downey's recent rally is a case of overall market strength rather than the fundamental strength of Downey itself. The stock has rallied from less than \$63 in March to more than \$70 as of late last week.

The percentage of Downey equity owned by hedge funds jumped to 38% at the end of the first quarter from 18% at the end of 2006, according numbers from Goldman Sachs Research and FactSet Research Systems Inc. While Jeffrey Gendell's Tontine has held the stock since the late 1990s when it traded at less than \$20, a bevy of new hedge fund entrants shows that Downey is one of the lenders they think will stay afloat. Gendell didn't return a call seeking comment. According to filings, a good chunk of Gendell's 2.7 million shares were bought at prices between \$40 and \$60, meaning he's currently sitting on

profits of more than \$30 million and perhaps much more.

Citadel Investment Group, **Highfields Capital Management** and **Kingdon Capital Management** were among the funds taking first-time positions in Downey during the first quarter, while existing shareholders **AQR Capital Management** and **Millennium Partners** added on. Those funds have all seen the value of their stakes grow and are banking on Downey's reliance more on prime rather than subprime lending to push those profits higher.

"[Hedge funds] just feel that Downey is so conservative that they will not have the same problems that some of these other companies have had," said Paul Miller, an analyst at investment bank Friedman Billings Ramsey & Co.

Downey doesn't issue the controversial "piggyback" loans and has trimmed its loan portfolio to cover areas with better housing markets. He said he talked to hedge funds last week that think a lot of the recent rise in Downey's stock is due to short covering, or the purchase of stock to replace stock that was previously borrowed in order to be sold.

"Some of it's a short bet and some of it is people trying to squeeze the shorts," said Miller, who doesn't own the stock and whose firm does not do investment banking for Downey.

Amit Chokshi, who in January

launched a hedge fund called **Kinnaras Capital Management**, is part of the growing short-selling community involved in Downey Financial. Short interest in the stock reached 10.7 million of the 27.9 million shares outstanding as of May 15, up from just 4.6 million on Feb. 15, the date of the last Nasdaq short interest report before bad subprime news about New Century Financial Corp. and HSBC Holdings PLC surfaced. That news sent down the prices of many subprime lenders, including Downey.

Chokshi said that while subprime loans make up less than 10% of Downey's portfolio, there are loans the company makes that could end up being problematic.

More than half of Downey's loans give borrowers the option for "negative amortization," which allows them to pay lower monthly payments for a five-year period, during which their loan balance actually increases. Once borrowers max out on their loans, Downey can change the terms and give the borrowers a higher rate. When home values stay the same or rise, those loans are no problem, but if the value falls, the borrower loses equity.

Downey's accounting for those loans, Chokshi said, doesn't reckon what might happen if some of those loans go

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For Virgin Media, Takeover Talk Counters Makeover Challenge

■ *Despite a relaunch, the TV, Internet and phone company hasn't been shiny and new enough to hold on to customers. The botched transformation has funds contemplating a takeover offer.*

BY MARA LEMOS STEIN

Where there's smoke, there's fire. The old adage seems to ring true for hedge funds that are in the Virgin Media Inc. trade for an eventual takeover.

The U.K.-based provider of television, broadband and telephone services made up of the merger of NTL Inc., Telewest Global Inc. and Virgin Mobile Holdings is again being talked about as a buyout target for private equity firms, only months after it re-launched itself under the new Virgin Media brand. Its stock price jumped to around \$26 a share last week compared with \$22.83 a share two weeks earlier, following a report in the U.K.'s Sunday Observer newspaper that private equity firms were considering a \$15 billion takeover bid. Add to that talk the growing investor impatience with the company's poor financial performance, and you have hedge funds betting on a lucrative takeover play in the name.

"There isn't tremendous downside here," said a portfolio manager with an event-driven hedge fund on the East Coast that is a holder of Virgin Media stock. "The shareholder base is restless, and I think management is also frustrated with the stock price."

Virgin Media is working on integrating last year's acquisitions of Telewest and Virgin Mobile and establishing itself as a provider of a bundled service that offers TV, Internet fixed-line and cellular phone, a so-called quad-play in contrast to a more common triple-play bun-

dle wherein mobile phone service isn't included. The process hasn't been smooth, and some observers think that makes it a prey for buyout firms.

First-quarter results reported on May 9 revealed a struggle to keep customers, especially in the highly competitive telephony arena, with the company losing 63,400 subscribers in the January-March period. Virgin Media booked an operating loss of GBP15.3 million in the first quarter of 2007, compared with operating income of GBP9.2 million in the fourth quarter of 2006.

The company's work to improve its profitability has been hurt by its dispute with British Sky Broadcasting Group, the satellite television company, over the prices the two companies are prepared to pay for each other's content. BSkyB is majority owned by News Corp., which is separately offering to buy Dow Jones & Co., the publisher of this newsletter, for \$5 billion.

The dispute has hit the courts, with Virgin Media suing BSkyB in the English High Court in London, alleging it engages in "abusive" behavior, through discriminatory pricing of its programs and channels. A slew of newspaper advertisements, with each company blaming the other for their inability to reach a deal, has caused customer confusion and affected Virgin Media's ability to sign up new users, the company said in its earnings release.

The problem is expected to affect Virgin Media's second-quarter results. Combined with the competitive challenges in the sector, it means intense pressure for the company, said Citigroup analyst Michael Williams in a report on May 9. He has a "hold" rating on the stock and a \$26 price target.

But the "issues of distribution and content [pricing] will be a permanent fight between cable providers," said a hedge fund manager with a large New York firm that is a holder of Virgin Media shares. It is Virgin's job to tune up its operations to deal with these situations more smoothly, he said.

In his view, the trade opportunity is based on the company's ability to improve its performance, gain more subscribers and optimize its capital structure. Improving its capital structure would allow Virgin Media to increase its debt load to implement shareholder-friendly measures such as a stock buyback or dividend payout. "If [Virgin Media] gets it wrong, expect more pressure from shareholders and bidders," said the fund manager.

The shareholder pressure got explicit after the first-quarter results, with its largest shareholder, Franklin Mutual Advisers LLC, saying in a regulatory filing on May 10 that it would seek discussions with Virgin Media over its strategic

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METRICS

Dow Jones Equity Market Neutral Index

as of 5/23/07

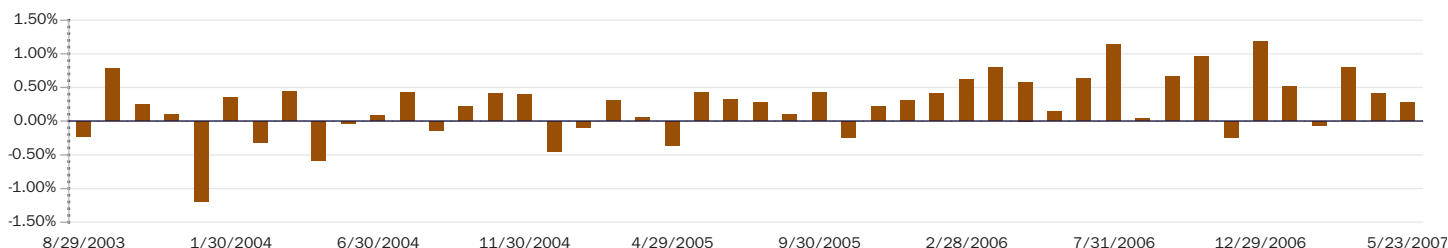
Each week, *Dow Jones Hedge Fund Trades* highlights one of six hedge fund investment strategies, compiled and tracked by *Dow Jones Hedge Fund Indexes*. Additional performance and information on the methodology can be found at www.djhedgefundindexes.com

Performance¹

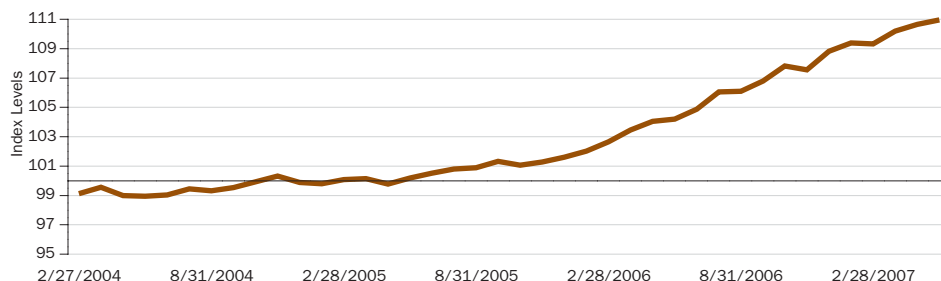
Index	One Month (%)	YTD (%)	2006 (%)	Since Inception (%)*	Vol. Since Incept.(%)*	Correl. w/DJW 5000	Correl. w/DJ CBI
DJHFSB: Equity Market Neutral	0.28	1.96	7.12	2.69	1.61	0.02	0.09
DJ Wilshire 5000 Float (DJW 5000)	2.89	8.51	15.77	15.40	7.86	1.00	-0.08
DJ Corporate Bond Index (DJ CBI)	-1.10	1.49	3.78	3.33	5.48	-0.08	1.00

*6/30/2003

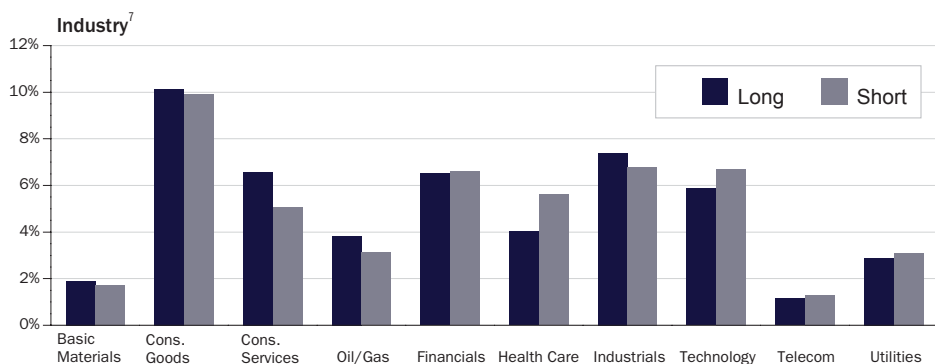
Monthly Returns After Fees¹



Benchmark Time Series¹



Exposure: US Stocks and Corporate Bonds⁶



Characteristics

Pre-Fee Reduction (PFR) NAV: ¹	123.12 M
Exposure-based Leverage: ²	186.6%
Liquidation-based Leverage: ²	93.4
Non-Third Party Pricing Exposure: ^{3,4}	0.0
Non-US Exposure: ^{3,5}	23.2

† estimate

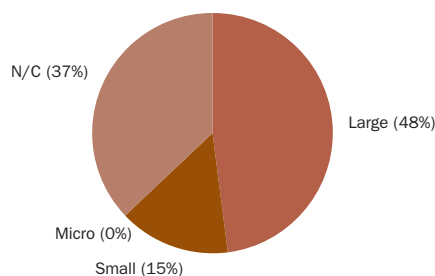
Asset Class Exposure

	Long (%)	Short (%)	Total (%)
Stocks	30.5	30.4	61.0
Bonds	0.0	0.0	0.0
Futures/Options	3.2	3.2	6.3
Cash/Other	32.7	0.0	32.7
Mutual Funds	0.0	0.0	0.0
Total	66.4	33.6	100.0

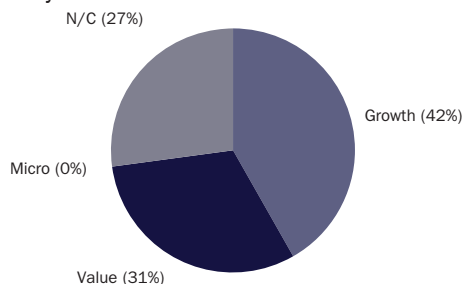
Notes

- Performance is net of fees and is based upon estimates and is subject to change.
- Exposure-based Leverage = (Long Position Value + Short Position Value) / Net Assets. Liquidation-based Leverage = Long Position Value / Net Assets. Both calculations measure the use of borrowed funds; the former from a risk perspective, and the latter from an accounting perspective.
- Gross exposure (i.e. long position values + short position values).
- Exposure to assets that are not priced by independent third parties.
- Exposure to assets not traded in the U.S.
- U.S. Stocks/Corporate Bonds represent approximately 40.94% of the gross exposure.
- Uses the Industry Classification Benchmark (ICB). No ICB industry classification available for approximately 0.04% of U.S. Stocks/Corporate Bonds.
- DJ Wilshire 5000 Index (DJW 5000) size and style classification. Not Classified implies not in the DJ Wilshire 5000 Index universe.

Size^{3,8}



Style^{3,8}



METRICS CONTINUED

Commentary

Equity market neutral funds in the Dow Jones Hedge Fund Strategy benchmark were up just 1.96% for the year through May 23. Only convertible arbitrage managers have a lower return in the index.

The most notable change market neutral managers have made is that they increased leverage to 100% in April, meaning they are investing all of the capital they have on hand. Managers in the strategy slightly increased their exposure to futures and options as well as long and short equity positions but changed little else in their portfolios.

The low returns of equity market neutral funds are partly a product of the bull market that seems like it will never end. When a fund is trying to do well regardless of how the market is doing - and the market is soaring - it tends to have lower returns than strategies that follow the indexes more closely.

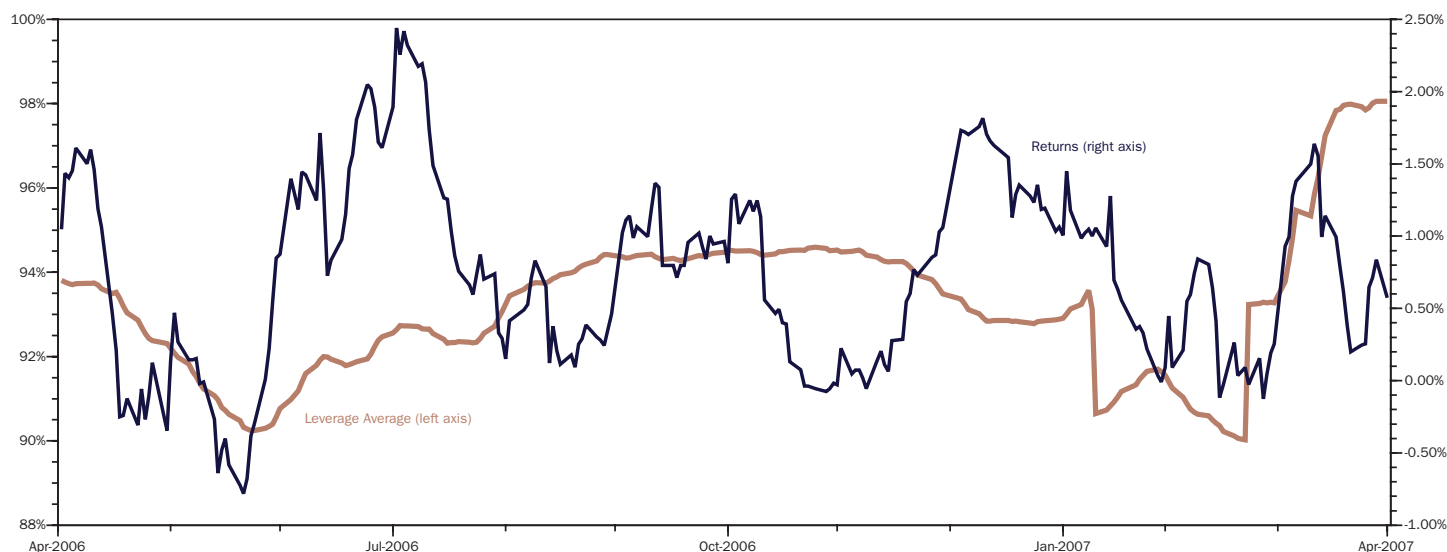
As of May 23, market neutral funds in the Dow Jones Hedge Fund Index had the lowest assets under management. However, if the markets suffer a prolonged sell-off, it is possible that demand for equity market neutral funds will grow.

In keeping with their strategy's risk-averse nature, market

neutral managers have seen volatility of just 2.18 for the year, compared with 8.71 for the Dow Jones Wilshire 5000 Index. That low volatility might really come in handy if the market suffers a downturn, as hedge fund investors will quickly turn to strategies that offer them downside protection.

While equity market neutral funds might not be the most popular choice for performance-hungry investors when stocks are high, the strategy will quickly come back into favor among cautious fund of funds and pensions, as well as individual hedge fund investors.

30 Day Rolling Returns And Leverage



Monthly Asset Class Exposure And Leverage†

Date	Stocks (%)		Bonds (%)		Futures/Options (%)		Cash/Other (%)		Mutual Funds (%)		Leverage (%)	
	Long	Short	Long	Short	Long	Short	Long	Short	Long	Short		
May 06	30.7	- 30.6	0.0	- 0.0	2.5	+ 2.5	33.6	+ 0.1	0.0	- 0.0	91	-
Jun 06	30.0	- 29.9	0.0	- 0.0	3.6	+ 3.6	32.8	- 0.1	0.0	- 0.0	91	-
Jul 06	31.3	+ 31.1	0.0	- 0.0	1.9	- 1.9	33.7	+ 0.0	0.0	- 0.0	92	+
Aug 06	31.1	- 31.0	0.0	- 0.0	2.4	+ 2.4	33.1	- 0.0	0.0	- 0.0	94	+
Sep 06	30.6	- 30.5	0.0	- 0.0	3.2	+ 3.2	32.4	- 0.0	0.0	- 0.0	94	+
Oct 06	31.6	+ 31.4	0.0	- 0.0	1.9	- 1.9	33.2	+ 0.0	0.0	- 0.0	95	+
Nov 06	31.4	- 31.2	0.0	- 0.0	2.1	+ 2.1	33.1	- 0.0	0.0	- 0.0	94	-
Dec 06	30.7	- 30.5	0.0	+ 0.0	2.9	+ 2.9	32.9	- 0.0	0.0	- 0.0	93	-
Jan 07	31.4	+ 31.3	0.0	+ 0.0	1.8	- 1.8	33.5	+ 0.0	0.0	- 0.0	93	+
Feb 07	31.1	- 31.0	0.1	+ 0.0	2.6	+ 2.6	32.7	- 0.1	0.0	- 0.0	95	+
Mar 07	30.0	- 29.7	0.0	- 0.0	2.1	- 2.1	36.0	+ 0.1	0.0	- 0.0	93	-
Apr 07	31.6	+ 31.4	0.0	+ 0.0	2.6	+ 2.6	31.7	- 0.2	0.0	+ 0.0	100	+

Change In Levels (Percentage Points)

12 months	-1.6	-1.5	0.0	0.0	0.3	0.3	2.6	0.0	0.0	0.0	-1
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12 Months

Avg	31.0	30.8	0.0	0.0	2.4	2.4	33.4	0.0	0.0	0.0	93
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Notes

† All exposures are expressed as a percent of gross exposures (i.e. long position + short position values) and based on the aggregated positions of component managers and are averages of the daily exposures over the month. Leverage = Long Position Value / Net Assets. The leverage calculation measures the use of borrowed funds from a liquidation perspective.

EQUITY

MMI Opposes Acxiom Deal With ValueAct, Silver Lake

MMI Investments L.P. disclosed that it recently sent a letter to Acxiom Corp. saying it intends to vote its shares against the company's proposed merger with Silver Lake Partners and ValueAct Capital.

According to a Securities and Exchange Commission filing, MMI Investments holds an 8.2% stake - about 6.46 million shares - in Acxiom, a Little Rock, Ark., provider of data and software used for direct marketing and customer-relationship management.

In the letter MMI said it's "extremely disappointed" by the Acxiom board's decision to accept the \$27.10-a-share offer from Silver Lake and ValueAct. It also said it believes the proposed merger price doesn't represent fair value for the shares, "based on a number of factors."

The New York firm also expressed concern regarding the sale of Acxiom and the structure of the sales process, including a "go-shop" provision that MMI believes is a "poor substitute for a full auction process."

MMI said it may engage in discussions with members of the company's board, management or other shareholders regarding the merger, potential alternatives, proposals for alternative transactions or structures to the merger, and the company's business, operations, governance, management, strategy and future plans. ■

INVESTORS

New Star's Hedge ETS To Issue Additional Shares In June

New Star Asset Management PLC said it will issue additional shares in

Treasurys Heat Up, Putting 5% 10-Year Yield In Play

BY LAURENCE NORMAN AND DEBORAH LYNN BLUMBERG

Some may find it hard to believe but Treasury markets have almost become exciting again.

After several months of turgid, range-bound trading - all the more painful with U.S. stock markets surging to record highs - Treasury prices have been battered in recent weeks, pushing yields up to 2007 highs.

On Thursday, a double-digit rise in April new home sales briefly lifted the 10-year yield to 4.90%, matching the intraday high it tapped Jan 26.

The question now is whether the 10-year yield can revisit a 5% mark not seen since last August, when the Federal Reserve was just starting its rates-on-hold period. A breach of this key psychological level could usher in a wave of selling as investors rethink their long-held view that the medium-term direction for yields is down.

That's a coin flip, traders say. While solid recent data, market momentum and developments in other asset classes suggest rates could climb further, the reappearance of foreign and domestic institutional buyers and some crucial upcoming data could easily contain the market's losses.

The market's recent funk started earlier this month after the Federal Reserve kept rates on hold for the seventh meeting running and reiterated that inflation remains its "predominant" concern. Since then, a string of decent-looking data kept prices under pressure, with labor market indicators, manufacturing and business spending data all looking firm.

Meanwhile, Thursday's new home sales data, which showed a 16.2% increase

in sales last month, was the latest pointer of some stabilization in the troubled housing market and, in general, investors seem much less concerned about the troubles in the subprime market.

These developments have caused investors to pare back rate cut expectations, so that from pricing in a good chance of two rate cuts in 2007 a few weeks ago, investors in interest-rate futures market gave odds of only 56% for a single rate cut early Thursday.

As Treasury prices turned downward, the move has snowballed. A few weeks ago, investors were holding very long positions in Treasurys - bets or exposure that assumed prices would rise. As the losses chalked up, they had to reverse those positions, paring their Treasury holdings and adding to the price declines.

William O' Donnell, head U.S. government bond strategist at UBS, said that while the market "is at least fair, if not cheap" based on the U.S. economy's current fragility, "we're more likely to test 5% than we are" to see a rally. Rates have "got the room to move through 5% and maybe move back toward last year's [price] lows of 5.25%."

O' Donnell said developments in equity markets are a key reason why rates are climbing - and may continue doing so. Not only does a rising stock market peel investors away from fixed-income buying, including some big time buyers like U.S. pension funds, it also softens the negative wealth effect of the housing market troubles and record

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Demand Destruction Seen Forcing Nickel Prices Down Further

BY ELISABETH BEHRMANN

New Star RBC Hedge 250 Index Exchange Traded Securities PCC Ltd., or Hedge ETS, a listed security linked to a hedge fund index.

The offer, which is expected to close June 21, follows Hedge ETS' initial \$150 million fundraising in November and a secondary offering in March that raised \$95.2 million.

New Star said a third tranche of shares is being issued to meet strong demand from investors but didn't say how much it hoped to raise.

"We expect interest from institutional investors and wealth managers seeking to benefit from the portfolio diversification benefits provided by hedge fund returns," Ravi Anand, New Star's head of structured products, said in a statement.

Hedge ETS' returns are linked to those on the RBC Hedge 250 Index, which was set up by Royal Bank of Canada's capital markets unit in July 2005. The index's constituent hedge funds collectively controlled \$230 billion at April 30, or about 11.5% of the world's estimated \$2 trillion in hedge fund assets. The annualized return on the index, net of a 0.95% fee, is 11.3%.

The return is higher than comparable investable indexes, such as HFRX Investable Hedge Fund Index2, which has an annualized return of 8.9%, and the MSCI Investable Hedge Fund Index2, which has returned 7.9% on an annualized basis.

Hedge ETS charges an additional 0.85% annual fee on Hedge ETS unleveraged shares and a 1% annual fee on a three-times leveraged version of the shares.

The shares are being issued under a global placing, excluding the U.S., and through a public offer in the U.K. UBS and Royal Bank of Canada are placing agents.

Listed shares linked to the

Nickel's wobble on the London Metal Exchange last week could be the first sign of prices succumbing to mounting evidence of demand destruction as a result of skyrocketing prices, market participants said.

Nickel's 5% tumble last Wednesday came in response to a large 1,446 metric tons stock addition in an LME Rotterdam warehouse, spooking funds and speculators that have been credited with adding significantly to nickel's extraordinary bull run on the back of tight supply and demand fundamentals.

"Demand destruction is very real and I'm only surprised the price has held up as well as it has. It [demand destruction] is running at multiple layers, such as replacing austenitic with ferritic alloys," said Alan Heap, Citigroup's managing director of global commodities.

Nickel is mainly used in stainless steel production, a sector that has more than doubled in China in the past year and is expected to grow by another 40% this year according to Macquaire.

Austenitic steel uses nickel as an alloying agent to make it resistant to corrosion, while ferritic steel contains chrome.

Stainless steel producers, particularly those in Asia, have also been at the forefront of efforts find cheaper substitutes for nickel, which some analysts now call the "newest precious metal."

"Two years ago this switch [to alternatives] was occurring and consumers had some bad experiences, but now it is happening again," said Heap.

Most metals have risen remarkably since the current commodity boom began at the start of 1999, with nickel

rising more than 1,200% to \$51,600/ton at the start of May.

China's voracious growth and surprise delays to future supply have been the key drivers in nickel's rise to previously unthinkable levels.

In early London trade last Thursday, however, LME nickel for three-month delivery dropped to a near seven-week low of \$45,400/ton, down \$700 on the Wednesday afternoon kerb.

"If there really is demand destruction, the money chasing the nickel price will probably flee. Stainless steel use as such is being reduced right now, and there is more use of lower-quality stainless steel [that contains less nickel], not only in Asia but also in Europe," said ANZ Analyst Andrew Harrington, who placed nickel's fair value below the \$40,000/ton mark.

Other options for substitution include galvanized steel that uses zinc as a protective layer, aluminum or replacing metal altogether with plastic solutions.

Stainless steel producers such as South Korea's Posco and China's Boasteel have developed technologies that minimize use of nickel or use new sources of the metal.

Posco announced the development of a non-nickel stainless steel last month, while Boasteel is developing more ways to use nickel-containing pig iron produced from low-grade ore, a relatively new feature in the market.

A direct response to the high nickel price, nickel pig iron first became available in late 2005. Output in 2006 ran at 25,000 tons but will now likely exceed

Continued on page 22

performance of hedge funds have proved popular with institutions and wealthy individuals as a way to get access to hedge funds without having to tie up their money for a year or more.

The shares can be traded in any amount on a daily basis. ■

FUND NEWS

Temasek Holdings Invests In Broad Peak Fund

BY MARGOT PATRICK

Singapore government investment firm Temasek Holdings Pte Ltd. has emerged as one of the major backers of **Broad Peak**, a \$1 billion hedge fund launched earlier this month by the former co-head of Goldman Sachs' Asian securities business.

Yap Chwee Mein, managing director of investment at Temasek, said Temasek is a founding investor in Singapore-based Broad Peak, adding to the firm's holdings in private equity funds and other private investments.

The move comes as other Asian government investment vehicles add alternative assets to their portfolios. China has agreed to take a \$3 billion investment in private equity firm Blackstone Group, while South Korea's Korea Investment Corp. said last month it is looking to make higher returns by moving into real estate and private equity funds.

A Temasek spokeswoman said the firm has made direct investments in hedge funds before, though Temasek doesn't disclose how much they make up of its S\$129 billion (\$84.3 billion) portfolio. Temasek also has exposure to hedge funds through its Fullerton Fund Management Co. subsidiary.

The spokeswoman declined to say how much Temasek has invested in

Canadian Dollar Likely To Keep Rising For Now

BY NICHOLAS HASTINGS

Further gains in the Canadian dollar are looking likely.

Although the currency hit a 30-year high against its U.S. counterpart last week and speculative positions in the futures market have risen sharply, both economic fundamentals and crude oil prices are set to continue working in its favor.

"Another spike in crude oil prices - be it Nigeria [related] or U.S. demand growth or cuts in China import duty - is a general dollar negative and may encourage yet more Canadian dollar outperformance," said Steve Pearson, a senior currency strategist with HBOS in London.

The Bank of Canada itself helped to strengthen market conviction about the currency's prospects when Governor David Dodge admitted last week that the strength of the Canadian currency is "consistent with fundamentals."

He also said that consumer price inflation, last measured at 2.5%, had been a little higher than expected in recent months and that the currency's impact on inflation will be considered in his bank's July monetary report.

This merely increased expectations that the bank will raise Canadian interest rates again, if not at its next meeting May 29 then certainly by its summer meeting July 10.

Not surprisingly, the U.S. dollar came under consistent selling pressure, falling to C\$1.0825, its lowest level since 1977.

Of course, concern exists over the strength of the U.S. economy and the impact it could have on the Canadian

economy, especially the manufacturing sector, given the close connection between the two economies.

But, as Hans Redeker, head of global currency strategy with BNP Paribas in London, pointed out, this will probably only be enough to prompt the Bank of Canada to "wait and see" on interest rates on May 29.

In the meantime, the currency is likely to continue getting support from the rally in crude oil prices.

Production problems in Nigeria, where militant groups continue to attack installations, planned oilfield maintenance in the North Sea, and the onset of the summer driving season in the U.S. not only give the impression that the recent rally in Brent crude futures to \$70 a barrel is justified but that these gains could be sustained and extended in the near term.

"In the near term, the current levels around \$70/b Brent are justified," said Michael Wittner, an economist with Calyon in London.

Nevertheless, some still see some downside risks to the Canadian currency's performance.

There are those who remain concerned that the Bank of Canada will prove more dovish at its next meeting and reduce expectations of the next rate rise.

Others feel that the rise in net long speculative positions on the Chicago Mercantile Exchange could get in the way. This is the fourth largest net long

Continued on page 21

SEC Mulls How Best To Monitor Hedge Funds

BY DAISY MAXEY

The Securities and Exchange Commission is still considering how best to monitor hedge funds, said Andrew J. Donohue, director of the Commission's Division of Investment Management.

However, some of the gap left when a D.C. Court of Appeals last year vacated a requirement that hedge funds register with the SEC has already been addressed, Donohue said. He made his comments at the Securities Industry and Financial Markets Association conference on hedge funds and alternatives in New York.

U.S. regulators should not succumb to "regulatory competition"

*Andrew J. Donohue
Director, SEC's Division of
Investment Management*

Despite the ruling overturning the registration requirement, about 2,000 hedge funds remain registered, and the SEC is now reviewing comments on two of its proposals that would further help monitor hedge funds, Donohue said.

About 350 hedge fund advisers appear to have withdrawn their registrations in the wake of the ruling, while 83 have registered since the decision, for a net reduction of about 270, he said.

In addition, the commission is working closely with fellow U.S. financial regulators to consider other measures, and paying close attention to how other countries regulate hedge funds, particularly the U.K.'s Financial Services Authority, he said.

The FSA requires hedge funds to register and imposes certain requirements,

he noted. U.S. regulators should not succumb to "regulatory competition," he said, but the differences are notable when the U.S. has been under fire for rigid requirements that have been blamed for driving some businesses abroad.

Retail investors are also gaining access to hedge fund-like strategies through mutual funds regulated under the Investment Company Act, he added.

The initial public offerings of some hedge fund advisers may also have some salutary effects on the industry, and could lead to a "more institutional mind-frame" in the managing of these private pools, Donohue said.

The hedge fund industry now manages more than \$1.8 trillion, and there are more than 10,000 single-manager funds, according to Randy Snook, senior managing director and executive vice president of SIFMA.

The SEC previously proposed a rule that would clarify the commission's ability to bring action against advisers who defraud investors in hedge funds or other pooled investment vehicles, and another that would require that investors in hedge funds have \$2.5 million in assets that can be invested, in addition to the \$1 million in net worth and \$200,000 that is now required of accredited investors. The comment period has closed on both these proposals, and the SEC is now closely reviewing the more than 500 comments it has received, Donohue said.

The president's working group on private pools of public capital has also

Continued on page 17

Broad Peak. A representative of Broad Peak also declined to comment.

Broad Peak started trading May 2 with about \$1 billion in investor commitments. It was founded by Hyder Ahmad, who until last summer oversaw Goldman Sachs' Asian sales and trading for stocks, bonds, derivatives, commodities and currencies.

Broad Peak, with 13 employees, invests across asset classes such as equities, bonds, currencies and commodities, as a so-called multistrategy hedge fund. ■

EQUITY

BlueCrest Invests In Siderean Software

BY SCOTT DENNE

Siderean Software Inc., a provider of information discovery software, has raised \$4.5 million venture capital funding, including \$2.5 million in debt from **BlueCrest Capital Finance L.P.** This is the second tranche of Siderean's Series A round.

The tranche includes \$2 million in equity financing from existing investors Clearstone Venture Partners, InnoCal Venture Capital and Red Rock Ventures, which provided the company with the \$6 million first tranche.

Earlier this year, BlueCrest, a hedge fund firm partly owned by U.K.-based Man Group PLC, acquired Ritchie Capital Management's debt finance business, which makes loans to start-up companies.

Siderean Software's flagship product, Seamark Navigator, establishes relationships among pieces of information on enterprise networks, enabling users to locate information based on categories rather than by using specific search terms, Michael Schmitt, the company's chief executive, said.

The money raised in this tranche will be invested in marketing and bolstering the company's sales and partnership channels, Schmitt said.

Founded in 2001, the El Segundo, Calif.-based company currently has fewer than 30 employees, Schmitt said. He added that it was too early to determine if the company would need additional financing. ■

FUND NEWS

SYZ, A&G Fondos To Offer Funds Of Hedge Funds In Spain

Swiss banking group SYZ & Co. has teamed up with Madrid-based asset management company Asesores y Gestores Financieros Fondos to offer two funds of hedge funds to retail investors in Spain, taking advantage of recent legislation opening up the market for these investments.

AYG SYZ Multi Strategy will invest in hedge fund operating across various strategies such as long/short equity, arbitrage and global macro while AYG SYZ Low Volatility will invest in a portfolio of hedge funds operating in low-volatility strategies with an overall lower risk level, the companies said.

Both funds will be open for investments of as little as EUR100.

Spain earlier this year started authorizing hedge funds and funds of hedge funds, following legislation last year to give institutional and retail investors broader access to hedge funds.

SYZ & Co.'s 3A SA alternative assets division will manage the funds, while A&G Fondos will market them to its own clients and to other distributors. ■

EQUITY

Third Point Seeks Resignation Of PDL's Chairman As Well As CEO

Third Point LLC, a New York hedge

EQUITY

OSI's Board Agrees To Sweetened Buyout Offer

BY RICHARD GIBSON

The sweetened bid for OSI Restaurant Partners Inc. disappointed some large shareholders yet may be enough to get the deal done.

Private equity giants Bain Capital Partners LLC and Catterton Management Co. LLC raised their \$40-a-share bid to \$41.15, and OSI's board accepted it, just hours before holders were to cast votes at a special meeting.

That meeting was postponed for the second time, until May 25. But balloting on whether to accept the revised offer now won't occur until June 5.

"there are enough weak holders out there who aren't going to hold out for more."

an institutional manager

"All that waiting for \$1.15," a portfolio manager at one of OSI's biggest institutional holders said. "Anyone who was a holder as of March 28 [the record date] who did not vote for this transaction will not be happy with it," he said. The manager, who wouldn't be identified, said his institution continues to oppose the deal at the current price.

At the same time, he thought it significant that in revising the bid, OSI didn't change the record date, meaning that arbitrageurs and others who picked up the stock in recent days, hoping for a quick buck, won't be allowed to vote.

That interpretation also assumes that the bidders thought there were enough undecideds to sway over to their side with an additional 2.8% cash offer.

A simple majority is required to approve the deal, and abstentions are counted as "no" votes. Founders and members of OSI management are not included in calculating the majority.

Another institutional manager whose fund remains opposed to the deal termed the sweetener "somewhat insulting, but a bit of a victory in that they had to pony up more."

She said she had been looking for at least \$2.

At the same time, she suggested that "there are enough weak holders out there who aren't going to hold out for more."

The manager surmised that neither Bain nor Catterton was willing to add to the pot and that the additional \$75 million or so probably came from the founders and other OSI insiders who are part of the buyout group.

A third institutional representative said the sweetener "points out that there's more value here" and that Bain and Catterton showed that "by blinking."

Although he indicated that the \$1.15 wasn't enough to buy his vote, the person worried that OSI and its proxy solicitors found sufficient potential support to put the deal over with what he views as a modest sweetener.

Some noted that in sweetening the offer, Bain and Catterton didn't characterize it as a "final and best" offer, perhaps indicating that a bit more may be forthcoming.

But Larry Miller, restaurant analyst at RBC Capital Markets, advised clients that the \$41.15 "may be sufficient to

Continued on page 17

fund, said it is seeking the resignation or termination of PDL BioPharma Inc.'s Chairman L. Patrick Gage as well as its Chief Executive Mark McDade.

Third Point, PDL's largest shareholder, said it doubts Gage and McDade "have fully and fairly presented our views to the board," and that a recent letter from Gage pays "lip service" to its demands.

An investigation by Third Point concluded that McDade "may have committed significant ethical breaches", adding the company has an employee morale problems and is in need of investor representation on the board.

A representative for PDL, a Fremont, Calif., biopharmaceutical firm, said the company won't comment on "personal attacks", but noted PDL will work with Third Point in a "constructive manner". ■

EQUITY

Elliott Group Wants Packeteer To Focus On Sale

A group including Elliott Associates L.P. reported holding a 6.3% stake in Packeteer Inc., and said it wants the company to direct its attention towards selling itself.

According to a Schedule 13D filed with the Securities and Exchange Commission, the Elliott group beneficially owns about 2.27 million shares of Packeteer, a Cupertino, Calif., provider of application performance and bandwidth management systems and software.

The New York-based investment manager said it believes Packeteer has "leading technology" in one of the fastest growing segments of the networking market, but has proven "unable to capitalize on such technology."

Elliott also said it believes the

EQUITY

Boone Pickens Eyes Payday In Clean Energy Fuels IPO

BY STEVE GELSI

Energy baron and 1980s corporate raider Boone Pickens will add more than \$70 million to his billion-dollar-plus fortune with Friday's debut of an initial public offering from Clean Energy Fuels Corp., a company he co-founded and invested in.

Clean Energy Fuels operates natural gas filling stations in California, Colorado, New Mexico, New York, Texas, Washington, Wyoming, British Columbia and Ontario, and a liquid natural gas plant in Willis, Texas.

Customers include Los Angeles International Airport, Phoenix Sky Harbor International Airport, SuperShuttle, Foothill Transit, Waste Management, Dallas-Ft. Worth International Airport, Sysco Foods, Denver International Airport and the US Navy.

The Sea Branch, Calif. company plans to offer 20 million shares at \$13-\$17 a share in a bid to raise about \$300 million in its IPO, which is expected to trade for the first time on Friday under the symbol CLNE on the Nasdaq.

The company narrowed its loss to \$861,000 on revenue of \$28 million in the three months ended March 31, compared to a loss of \$3 million on revenue of \$21 million in the year-ago period.

The IPO is tapping into strong demand for energy-related companies both from the traditional oil and gas businesses as well as alternative energy players from the solar and ethanol sectors.

Clean Energy Fuels Corp. traces its roots to the 1980s, when Pickens, "became convinced that natural gas had a number of advantages over gasoline

and diesel as a vehicle fuel," the company said in its IPO prospectus.

Over the next 15 years, Pickens and Clean Energy CEO Andrew Littlefair worked to develop the market through vehicle fleets that run on natural gas, which burns cleaner than gasoline or diesel. Natural gas is also widely produced in North America, unlike imported oil.

Pickens, known as a corporate raider in the 1980s after amassing a fortune in the oil and natural gas business, invested about \$32 million in cash in the company between 2004 and 2006 and floated the company a \$50 million line a credit to fund margin calls related to its futures contracts, according to the company's IPO filing. The credit line was increased to \$100 million in 2006.

In December, Pickens canceled about \$69.7 million of debt obligations and assumed all of the company's outstanding futures contracts, together with all associated liabilities and obligations of approximately \$78.7 million, in exchange for a five-year warrant to purchase up to 15 million shares of common stock at \$10 a share.

Pickens is selling about 4.9 million shares in the IPO for estimated proceeds of about \$70 million based on an IPO price at the midpoint of the company's \$13-\$17 range. His wife Madeline Pickens is selling 1 million shares.

After the IPO, Boone Pickens will own about 29 million shares worth \$435 million as the company's biggest shareholder. Other shareholders include

Continued on page 17

business segment in which Packeteer operates is becoming “increasingly competitive,” and that the company’s technology may prove “extremely valuable to a larger acquirer looking to enter the wide area network optimization market” or to supplement its current product offering. ■

EQUITY

Brencourt Advisors Opposes Vertrue Merger

Brencourt Advisors LLC, a 9.66% stakeholder of Vertrue Inc., said it opposes the proposed acquisition of the company by One Equity Partners, citing the \$48.50-a-share offer price is “too low”.

In a letter sent to Brencourt Chairman Gary A Johnson, Brencourt said it believes that there are other ways to increase shareholder value other than by “accepting a low ball bid” for the company.

Brencourt also encouraged the board to revisit a leveraged recapitalization of the company’s balance sheet and to use those proceeds to fund a special dividend to shareholders, according to the letter, which was disclosed in a filing with the Securities and Exchange Commission.

Vertrue, a Norwalk, Conn. Internet direct marketing company, in March agreed to be acquired by a group including members of its management, One Equity Partners, Oak Investment Partners and Rho Ventures, for \$800 million, or \$48.50 a share in cash. ■

REGULATORY

Hedge Funds Said Beneficial For Japan Markets

Japan’s Financial Services Minister Yuji Yamamoto said that hedge fund players benefit Japanese financial markets as they help raise their

EQUITY

Buffett, Icahn Have Different Motives In Buying Railroads

Warren Buffett and Carl Icahn, influential investors with very different stock picking styles, have hitched a ride on the same sector - railroads.

Last week, both disclosed stakes in a handful of the nation’s largest railroad companies. Their interest, say analysts familiar with the sector, couldn’t be more different. But they both attest to the recent recovery of an industry that spent over two decades in the dog house.

In one investing camp, Buffett and his Berkshire Hathaway Inc. investment company are making a play on long-term demand for U.S. freight transportation, driven by shipments of coal, grains and overseas goods. There is a finite supply: The seven largest railroad companies in the United States operate 68% of the freight mileage and capture 93% of the freight revenue.

And, the investment thesis holds, the nation’s diesel-powered railroads have a cost advantage over rivals in the trucking business as oil prices continue to rise.

“Higher diesel costs raise costs for railroads, but not as much as for trucking,” as Buffett himself put it when he addressed shareholders at Berkshire Hathaway’s annual meeting earlier this month.

In another camp are the growing ranks of activist-oriented hedge funds that push management to make changes, say a sale or share buyback, that will boost the value of their holdings.

In addition to Icahn and his investment affiliates, other big groups that have taken stakes in the rail industry recently include **The Children’s Investment Fund Management LLP**, a London-based institution, and **SAC**

Capital, a high-flying hedge fund in Stamford, Conn.

Their bullishness comes at a time when railroads are enjoying rich levels of cash, which have risen as operators pay down debt, analysts said. More cash on the books represents an opportunity to return some of that value to shareholders in a special dividend or buyback.

“There’s a belief that the railroads need to increase their leverage to return cash to shareholders - that’s what’s driving the activist investors,” said Salvatore Vitale, a railroad stock analyst at Calyon Securities.

Rarely since the days of their industrial baron founders have the railroads, including Burlington Northern Santa Fe, Union Pacific Corp., and Norfolk Southern Corp., seen such high-powered backing.

“It’s been viewed as a cyclical industry - a few good years, a few bad years,” said Don Hodges, co-portfolio manager of the \$664 million Hodges Fund, which bought into Burlington Northern in July 2004 and has since added shares in Canadian National Railway Co., Norfolk Southern and Union Pacific.

But broader trends that fall outside the business cycle, such as China’s rapid growth as an exporter to the United States of finished goods, are also weighing in the sector’s favor.

“All of a sudden, there are some people out there beginning to say that this is a growth industry,” he said.

Buffett has been one investor to change his tune of late. On Tuesday, Berkshire revealed additional stakes in

Continued on page 23

liquidity and efficiency.

Even if the government tries to make rules to regulate their activities, fund players will come up with new ways to get around them, so it's meaningless to regulate funds, Yamamoto said in a speech to the American Chamber of Commerce in Japan. Yamamoto's remarks are in line with the government's stance, given after the Group of Eight financial ministers' meeting in Germany, that it is reluctant to regulate hedge funds because such regulation may impede the freedom of financial markets. ■

INDUSTRY NEWS

Deutsche Bank's Ackermann Defends Active Shareholders

Deutsche Bank AG's Chief Executive Josef Ackermann came to the defense of private equity companies and hedge funds that take an active interest in the companies they invest in.

Speaking at the annual German investor relations conference in Frankfurt, the CEO of Germany's largest bank by market capitalization said it should go without saying that owners of companies take an active interest in corporate strategy.

That investors actively express their expectations as to strategy, also against management, and that they have opinions about, and fight for return on their investments in the form of payout of profits, "is still met with no understanding in Germany."

"This is very regrettable," Ackermann said.

"We should be open to the interest of foreign investors who bring capital and expertise in Germany," he added.

He noted, however, that the private equity and hedge fund business is still young and needs to mature still, especially when it comes to communication, and called for more

Tudor Investment To Inject \$100M Into India Fund

BY LAURA SANTINI

Tudor Investment Corp., a \$16.8 billion hedge fund based in Greenwich, Conn., is injecting \$100 million into Helios Capital Management Pte. Ltd. and will take a 15% equity stake in the India-focused investment firm, according to people familiar with the arrangement.

The deal illustrates a familiar strategy of many U.S. hedge funds eager to gain investment exposure in Asia. In addition to simply moving talent to the region, some have opted to invest in local management, already steeped in a particular market and its opportunities and pitfalls.

Pequot Capital Management, for instance, helped launch investment fund Pangaea Capital Management in Singapore, and Morgan Stanley is contributing seed money to **Abax Global Capital**, a hedge fund started by former Citadel managing director Chris Hsu that begins operations in July.

Founded in 1980 by Paul Tudor Jones, Tudor Investment itself acquired a Singapore-based fixed-income team a few years back called Pagoda Advisors.

A Tudor spokesman didn't provide comment by press time.

Helios, also based in Singapore, is managed by Samir Arora, formerly of U.S. money manager Alliance Capital Management.

Tudor already has invested half the sum in an existing India-focused Helios fund that buys Indian shares, offsetting some of the risk with equity futures.

Helios is in the process of launching a second fund, wider in scope, that plans to execute private equity arrangements,

invest in property and debt and buy publicly traded stocks.

Tudor has agreed to sock away the remaining \$50 million in the second fund. It is unclear whether the U.S. fund will need to put up additional capital to gain the 15% stake or whether the equity ownership represents part of its investment deal.

India's stock market has gained an underwhelming 3.4% so far this year after clocking 40%-plus growth in both 2005 and 2006.

While Tudor's investment is a sign of continued bullishness on the prospects for Indian shares, the second fund shows that money managers operating in India are keen to broaden their investment mix in an effort to revive the sizzling returns of the previous years.

Helios, with \$490 million under management, has reported producing a 90% return since launching its first fund in July 2005. ■

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transparency to facilitate an informed discussion between all parties.

Ackermann's comments come a couple weeks after New York hedge fund **Atticus Capital L.P.** criticised German stock exchange Deutsche Boerse AG's plan to acquire U.S options exchange International Securities Exchange Inc. The hedge fund, which holds close to 8.9% in the German exchange, had previously called for an expansion of the company's capital management program under which it returned cash to shareholders in the form of dividends and share buybacks. ■

Will And Grace

Continued from page 3

holder, the business is in good shape. On April 25, the company reported that first-quarter 2007 sales were \$715.6 million, an 8.7% increase over the prior year's first quarter sales.

"It's rare that you've got such a good company in bankruptcy," the manager said. "Most of the time, there are fundamental issues destroying it."

The analyst at the New York-based fund pointed to the success of another specialty chemical company, Albermale Corp., which is a competitor of Grace that's not in bankruptcy and has seen its stock price double in the past year to an all-time high amid higher demand for its products.

With the wins in the courtroom, as well as the fact that W.R. Grace has wide distribution of its products, W.R. Grace's stock might still soar, even though it's in bankruptcy and still hasn't offered an exit plan, said the manager who's a longtime holder.

"My view is that bankruptcy is very friendly to a business with a good franchise," the manager said.

Perhaps it will be as friendly as W.R. Grace has been to its hedge fund holders. ■

More Hedge Fund IPOs Seen This Year

BY DAVID ENRICH AND KAJA WHITEHOUSE

In the wake of **Fortress Investment Group LLC's** successful initial public offering, more hedge funds are likely to go public this year, according to investment bankers speaking at an industry conference.

The desire for a currency to attract and retain talent in a competitive industry environment is a key force behind the increased interest in IPOs. Bankers say that many of their hedge-fund clients are looking at the possibility of going public.

Souren Ouzounian, managing director in Merrill Lynch & Co.'s investment bank, said he has about six hedge fund clients that are mulling IPOs. Michael Rees, a Lehman Brothers Holdings Inc. investment banker, said four of his clients are positioned to file in "the fairly near term."

"They're big firms," Rees said at the Hedge Fund Leadership Forum in New York.

The interest in going public comes after Fortress' stock debut drew strong interest from investors. Another hedge fund firm, **Oaktree Capital Management LLC**, sold shares in its management company in a private placement this week. The IPO of Blackstone Group, a New York private equity firm, is also expected to attract heavy investor interest this summer.

In addition to wanting to use equity to lure talent, hedge funds also hope to be able to use capital raised in their IPOs for deal making. There's also a fear of being left behind as rivals go public.

"They don't want to wake up in 12 to 18 months and have 75% of their competitors have access to a public currency to retain and attract talent that they

don't have," Rees said.

But skeptics contend that the IPO trend largely reflects some fund managers' desire to cash out at the top of the market.

"There's no clear use for the money," said Harry Krensky, principal at Atlas Discovery Capital, in White Plains, N.Y. "The only use of the money I can see is to cash out management."

Aside from traditional IPOs, an increasing number of hedge funds are looking to sell minority stakes in themselves to other investors. Bankers said that institutions ranging from overseas governments to insurance companies to private-equity firms are all in the market to buy positions in hedge funds.

"We're seeing a lot more activity, a lot more tires being kicked," Rees said.

Bankers also said that hedge funds are likely to increasingly turn to debt as well as equity markets in coming months. ■

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Hedge Fund Monitoring

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focused on better coordinating hedge fund oversight, and endorsed limiting the availability of private investment pools to sophisticated investors, Donohue noted. The group is working to ensure that investors receive timely information on these investments, he said.

The increasing use of hedge funds by institutions, such as pensions, which may be more risk-averse and require more transparency and reliable valuation techniques, has made risk management more sophisticated, Donohue said. ■

OSI Restaurant Partners

Continued from page 12

close the deal.”

He said that “there are still many shareholders who would find this revised offer unacceptable, particularly given the 7.5% increase in the S&P 500 year-to-date, and their view of the intrinsic value of OSI.

“However, we think this increase could be sufficient to get this deal done,” he wrote.

“We would hang on to our shares until the deal was approved,” Miller added. ■

Pickens/Clean Energy

Continued from page 13

Westport Innovations Inc. and Perseus 2000 LLC.

Pickens, 78, made No. 4 on the Forbes list of top earners on Wall Street with a wallet of \$1.1 billion in 2006 for his hedge fund, **BP Capital**. The fund made \$1.8 billion by successfully betting on a decline in natural gas prices last year.

Pickens was also a shareholder in the IPO of Exco Resources, an independent oil and natural gas company that went public at \$13 a share in February 2006. ■

DEBT

Fund Manager Says MBIA, Ambac Exposed To Subprime Fallout

BY ALISTAIR BARR

MMBIA Inc. and Ambac Financial Group are exposed to the fallout in the subprime mortgage sector and that may prove costly for the bond guarantors’ policyholders who are probably holding the ultimate risk and could end up with big losses, Bill Ackman, president of hedge fund firm **Pershing Square Capital Management**, said during a presentation.

Rising interest rates and flat house prices have sparked a jump in delinquencies and foreclosures...increasing concern that losses will likely hit some of the riskiest tranches, of subprime mortgage-backed securities

The hedge fund manager disclosed that he has short positions in MBIA and Ambac shares and also owns credit protection on the companies. Both types of trades can increase in value if the companies struggle and their perceived ability to repay debt declines. Ackman has criticized MBIA in the past.

A spokesman for MBIA declined to comment. Ambac spokesman Peter Poillon didn’t immediately return a phone call and email seeking comment on Thursday afternoon.

Ackman spoke at a conference organized by the Ira Sohn Research Conference Foundation, which funds the treatment and cure of pediatric cancer and other childhood diseases.

In a presentation entitled “Who’s Holding the Bag?” Pershing’s Ackman focused on the shakeout in the subprime mortgage sector and which companies and investors might be hurt most by the trend. MarketWatch obtained a copy of the presentation on Thursday.

Subprime mortgages are offered to poorer home buyers with blemished credit records. Rising interest rates and flat house prices have sparked a jump in delinquencies and foreclosures.

That has increased concern that losses will likely hit some of the riskiest parts, or tranches, of subprime mortgage-backed securities, or MBS. Then collateralized debt obligations (CDOs), which invested in some of the lowest-rated subprime MBS tranches, will feel the pain, experts worry.

MBIA and Ambac, which guarantee MBS and CDOs, have significant exposures to subprime mortgages, according to Ackman’s presentation.

Ambac has \$18.7 billion in subprime exposure through guarantees of MBS or CDOs, according to Ackman’s presentation. That’s a little over 284% of the company’s statutory capital, he noted.

MBIA has \$24.7 billion of “high-risk” credit exposure, which includes direct subprime exposure and more indirect exposure through CDOs, Ackman’s presentation said. The company’s exposure to so-called mezzanine CDOs, with underlying collateral rated BBB or lower, was \$5 billion at the end

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of 2006, which is 73.5% of its statutory capital, he added.

The customers of Ambac and MBIA believe they have transferred credit risk to highly rated guarantors. But when subprime mortgage losses hit, these guarantees “will have no value” and the policyholders will be “left holding the bag,” Ackman’s presentation concluded.

MBIA and Ambac should put more money into their insurance subsidiaries to prepare for possible subprime losses. Executives should be “removed” and MBIA should have an independent board of directors, Ackman added.

Still, Ackman’s views aren’t shared by some analysts.

Ken Zerbe, an analyst at Morgan Stanley, said in a March 21 report that concern about the subprime exposure of the financial guarantors had created a buying opportunity.

Ambac has more than \$10 billion of direct subprime-mortgage exposure, while MBIA has a little under \$6 billion, Zerbe found. That looks big, but it’s only 2% and 0.9% of the companies’ respective total exposures, he noted.

“While the guarantors have large dollar exposures to the subprime market, high levels of subordination provide significant protection against rising losses,” he wrote in a note to clients.

MBIA’s chief financial officer said in late April that developments in the subprime mortgage market hadn’t caused “any significant concerns regarding our insured book of business.”

MBIA has been “cautious” on residential MBS and since 2002 has “stepped away” from the market, he added, according to a transcript of a conference call with analysts. ■

Galloway Capital Seeks Ouster Of Stonepath Group Board

BY PATRICK FITZGERALD

ANew York hedge fund is seeking the ouster of three directors of Stonepath Group Inc., the latest blow to the troubled Seattle logistics firm.

In a letter sent to Stonepath Group, **Galloway Capital Management** demanded the removal of three directors from the company’s board.

“We want to replace the board with our own slate,” said Galloway managing member Gary Herman. That slate includes Herman as well as former Stonepath chief executive Robert Arovas.

Galloway also demanded that Stonepath Group hand over the names of the company’s shareholders. Galloway Capital and its affiliate Strategic Turnaround Partners own 3.95 million shares, or 9%, in Stonepath Group.

The investment firm is seeking to oust Stonepath directors Slobodan Andjic, Martin Muller-Romheld and Nowroz Jal Cama. Andjic and Muller-Romheld joined the board in February after Mass Financial Corp. purchased Stonepath’s debt.

Last month, Muller-Romheld was named CEO of the company after Arovas was dismissed.

The letter, which was made public in a regulatory filing, comes two weeks after a group of creditors tried to force Stonepath Group into bankruptcy.

On May 8, three trade creditors filed an involuntary Chapter 7 petition against the company in the U.S. Bankruptcy Court in Wilmington, Del. Staffing firm Spherion Inc. and two Minnesota shipping companies claim Stonepath owes them \$1.1 million.

The creditors want a bankruptcy

judge to name a trustee to take over the company and sell Stonepath’s assets under a Chapter 7 liquidation. Unlike Chapter 11, whereby a company reorganizes under a bankruptcy court’s supervision, in Chapter 7 a trustee is appointed to liquidate a company’s assets.

According to court papers, Stonepath hasn’t responded to the creditors’ bid to force them into bankruptcy.

Under bankruptcy law, Stonepath has 20 days to respond to the involuntary Chapter 7 petition. Among its options, the company could seek to contest the bankruptcy or have the case converted to a reorganization under Chapter 11 of the Bankruptcy Code.

Stonepath Group didn’t return calls for comment. Last month, the American Stock Exchange suspended trading of the company’s stock because it hadn’t filed its annual report.

The company has also received a notice of default from lender Mass Financial Corp. for \$5.8 million in debt. Mass Financial, which purchased Stonepath’s debt from Laurus Master Fund Ltd. in February, has foreclosed on collateral securing the loan, namely the company’s stake in two logistics subsidiaries.

Court-appointed receivers have also been appointed to run Stonepath’s Hong Kong unit since lenders said the company defaulted on \$7 million in debt because it didn’t make a scheduled interest payment. Stonepath is contesting the alleged default.

Founded in 1998, Stonepath at one

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KBR Finds Partners

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valued below that of its peers because Wall Street tends to focus on a quarter-by-quarter analysis of earnings before interest, tax, depreciation and amortization, and earnings in the stand-alone KBR came in below projections in the first quarter, at \$28 million or 17 cents per share. The consensus among Wall Street analysts polled by Thomson Financial was for per-share earnings of 24 cents but included a charge from discontinued operations.

Hedge funds, meanwhile, were salivating over the reported \$1.3 billion of cash and cash equivalents on KBR's balance sheet.

One portfolio manager at a long/short equity hedge fund in New York with a stake in KBR said that when it first considered the investment, he noticed that the company's cash in hand was nearly half of its market capitalization. The Houston-based company's current market cap is \$4.76 billion.

Although much of KBR's cash is earmarked for working-capital requirements and some of it is advanced billings for work yet to be performed, about \$300 million to \$400 million is available for strategic purposes that may include opportunistic acquisitions and returning capital to investors, Cedric Burgher, the company's chief financial officer, said in a conference call on May 4.

KBR is a pioneer in the design and construction of facilities to transform natural gas into commercial products, and its strength lies in its leading position in the liquefied natural gas and gas-to-liquid markets, said the New York manager. Echoing other hedge funds in the stock, he is confident the new management at KBR's helm is capable of steering the company into growth now that it is free of Halliburton.

Hedge funds view the May 14 award

of contracts to provide field construction and module fabrication services for Shell Canada's expansion of operations in the Athabasca Oil Sands Project in Edmonton, Alberta, as an example of KBR's ability to broaden its focus of business in the oilfields services sector. Funds also approved of the company's sale for GBP350 million of its 51% interest in the Devonport Management Ltd., which performed refueling and maintenance of the U.K.'s fleet of nuclear submarines through its subsidiary Devonport Royal Dockyard.

"The turnaround story is that the company will be more selective in what projects to pursue," said the New York manager, who spoke on condition of anonymity.

But some remain cautious. Goldman Sachs' analyst Al Kabili said in a note dated May 6 that KBR must prove its ability to grow and win new contracts, and to manage some of its troubled projects, such as the Escravos gas-to-liquid project in Nigeria, which has been a cost burden. Kabili has a neutral rating on the stock and a six-month price target of \$22 per share. Goldman Sachs expects to get compensation for investment banking services to KBR in the next three months, and it managed offerings of public or Rule 144A securities by the company in the past 12 months. It is a market-maker and market specialist in the stock.

KBR's stock is trading at a discount to its competitors, which include CB&I (Chicago Bridge & Iron Company N.V.), Foster Wheeler Ltd., Jacobs Engineering Group Inc., Fluor Corp. and Shaw Group Inc. But as the company moves forward addressing its more troubled contracts such as that with Escravos, the valuation gap to its peers should close, said the analyst with the West Coast hedge fund. "And management appears to be advancing the ball in the right direction."

Even those that got into the trade for the small arbitrage from the split-off saw some hidden value in the company. The exchange offer, whereby holders of Halliburton shares would get KBR shares at a discount, was three times oversubscribed. The exchange on April 2 was priced at a maximum ratio calculated by taking the average of the daily volume-weighted average for share prices March 27-29, meaning traders got 1.59 shares of KBR for every Halliburton share, or around \$1.08 of KBR stock for every \$1 of Halliburton stock. That maximum ratio meant the planned discount of 7.5% for KBR shares to their price in the stock market quickly eroded. Hedge funds said that the discount was under 2%, but it wasn't negligible enough to be passed up by those involved in event-driven plays.

"We have been involved in it because of the transaction with Halliburton and have only a small position remaining," said Ned Sadaka, portfolio manager of **Para Advisors**, a special-situations hedge fund in New York. "The stock appeared very attractive in relation to other engineering and construction businesses. Compared with Foster Wheeler, it was trading at a large discount. That's why we stayed with the name," he said. But at over \$27 per share, it made sense to sell, said Sadaka.

On Thursday, KBR stock traded on the NYSE ended at \$26.18 per share, compared with around \$20 per share in the two weeks leading up to the split-off on April 5.

Another issue that hedge funds say cast a shadow over KBR is its status as the sole contractor for providing food and shelter for the military in Afghanistan and Iraq. The U.S. public and Congress are growing increasingly impatient with the costs of the opera-

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KBR Finds Partners

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tions and human loss, especially in Iraq. The company is under scrutiny for alleged fraud and contract abuses, and investors fret that if the U.S. pulls out of Iraq sooner rather than later, KBR would lose a large source of revenue. It is currently working on a \$3.5 billion job awarded in the third phase of the government's military program in these countries, and it expects to get a new award for services beyond 2007.

But hedge funds noted that KBR's military work is a low-margin business.

"Just the revenue line shows a lot of exposure to the military, but the more important metric for us is the cash flow," said the analyst at the West Coast fund. "The energy business is a much higher margin than the government business and a lot of people don't realize that." He said that even if the U.S. reduces its military presence in Iraq, it's safe to assume "that the military will be operating at a high activity level for quite some time to come, regardless of where they may be, and KBR will be a part of that. They won't fall off a cliff anytime soon."

Perhaps concerns that the Democratic majority in the U.S. Congress would set a deadline for troops' withdrawal inspired short sellers into betting against KBR in recent months. New York Stock Exchange data

show that short positions rose to 15.2 million in mid-March from 2.7 million a month earlier and continued to rise to nearly 20 million in mid-April. But the number disclosed last week for short positions as of May 15 revealed only 4.7 million KBR shares were sold short from a total 168.8 million outstanding. But the high short interest was also likely reflecting a technical trade relating to the separation from Halliburton, with owners of Halliburton isolating out the KBR risk by selling it short ahead of the split, said hedge fund managers and analysts.

The largest holder of the company's stock is **Tontine Associates**, with 18.4 million shares worth around \$515 million at current market prices. Filings with the Securities and Exchange Commission show that the Greenwich, Conn.-based hedge fund run by Jeffrey Gendell has been increasing its position in KBR since the split from Halliburton.

In a filing in early April relating to the firm's holdings as of March 30, Gendell disclosed that his funds had 8.3% of KBR stock, or 13.9 million shares. About 2.7 million of those shares were acquired in the exchange offer by Halliburton, the 13G filing said. That filing was amended last week, when Tontine said it had raised its stake in KBR to 11%, or 18.4 million shares, as of May 8. Thus, Gendell purchased 5 million shares of KBR in the open mar-

ket in April, when the stock traded between \$20.13 and \$22.39 a share and is holding a neat paper gain in the trade.

KBR is Tontine's third-largest equity holding of around \$12 billion. The hedge fund manager tends to stay in positions for the long term, was an early investor in the steel sector and profited from that trade as the sector has rebounded. Gendell declined to comment.

The second-largest holder of KBR is **Jana Partners**, with 3.8 million shares as of March 31, worth approximately \$107 million at current prices. Jana, a multibillion-dollar hedge fund run by Barry Rosenstein, has around 20% of its \$6.2 billion equity portfolio allocated to companies in the oil and gas industry. It acquired its entire stake in KBR during the first quarter, filings show.

Another hedge fund known for its value-oriented approach to investment - **Ivory Investment Management** - is the third-largest holder of KBR, with 3.2 million shares as of March 31, worth around \$89 million. Ivory, based in Santa Monica, Calif., manages a long equity portfolio of around \$3.6 billion.

Other hedge funds with KBR stakes worth in excess of \$35 million each are **Aristeia Capital**, **SAB Capital Management** and **Okumus Capital**.

They all seem to share the rationale of the analyst with the West Coast hedge fund: "It's cheap and the business is going well. What more can I say?" ■

From Dow Jones

Hedge Fund Trades

Charting the Strategies of Absolute Return Fund Managers

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Downey Seen Holding Up

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bad. In the meantime, though, he said wider market sentiment may keep the stock price high, perhaps for as long as another year.

“It’s definitely not going to [fall] overnight,” Chokshi said. Once it does

start dropping, he said, the stock could go down to around \$50 per share, and if that occurs then a lot of the funds that bought into the stock in February would experience losses.

In the meantime, according to the analyst Miller, hedge funds that want to find some long bets in the lending community are going with Downey and, to a

lesser extent, FirstFed Financial Corp. because of their lower exposure to sub-prime loans. FirstFed has also risen since early March, from the low \$50s to the mid-\$60s.

“Hedge funds now are saying, ‘I want to be short some other mortgage names, but these guys will probably hold up a lot better,’” Miller said. ■

Treasuries Break From Range

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high gasoline prices - adding to the pressure on Treasuries.

Developments in mortgage markets are also weighing. When Treasury yields rise rapidly, mortgage bond investors tend to sell longer-maturing assets, such as mortgage bonds or Treasuries, in an effort to lessen the duration - or sensitivity to interest rate changes - of their portfolios.

That started to happen when the 10-year yield first lifted to 4.65%, said Walt Schmidt, manager of mortgage products and strategy for FTN Financial in Chicago. He said that if the 10-year yield hits 5% again, it could cause a large wave of further selling.

Yet there are several caveats to this doom-and-gloom scenario, not least Thursday’s price action.

While the 10-year yield initially climbed to 4.90%, prices quickly came back despite this week’s string of strong

data. By early afternoon, Treasuries had regained most of their morning losses with the 10-year note down just 2/32 to yield 4.87%.

What’s more, the market is reaching levels where, in recent months, large-scale buyers, including U.S. institutions and overseas central banks, have repeatedly started back in.

“We have hit some real technical buy signals in the 10-year, and I think that’s going to keep us from going through 4.90%,” said Kevin Giddis, managing director of fixed income with Morgan Keegan & Co. “I just don’t think we’ve got enough [momentum] to push through.”

Another potential support for the market is the approaching month-end duration extension, which is expected to be strong in May. When that happens, bond fund managers ratchet up portfolio duration and rebalance their portfolios to match Lehman’s benchmark indexes.

Ultimately, whether rates keep heading higher or stage a reversal is likely to

be decided by how next week’s plethora of data turns out. In addition to manufacturing data and revised first quarter growth numbers, the U.S. reports May nonfarm payrolls and the Fed’s favored inflation gauge - the personal consumption expenditure price index.

A combination of strong payrolls and a rebound in the annual increase in the ex-food, ex-energy PCE price index would make a 5% 10-year yield look eminently attainable. But if payrolls come in below expectations for the second month running and the core PCE is soft, the market may start dreaming of a rate cut again, helping Treasuries recover.

Richard Gilhooly, senior fixed income strategist at BNP Paribas in New York, said a strong jobs report this coming Friday could lift the 10-year yield to 4.95%.

Nonetheless, he said, “we’ve already sold off a lot...I don’t think we’ll get there.” ■

Danielle Reed contributed to this article

Canadian Dollar To Rise

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position ever held in the currency and could well provide a “headwind” that prevents the U.S. dollar from sliding seriously under \$1.0800, according to Antje Praefcke, a currency strategist with Commerzbank in Frankfurt.

However, Greg Anderson, a cur-

rency strategist with ABN-Amro in Chicago, suggests that there should still be room for gains. “We do not believe positioning is extreme enough to deter further downside risks in the U.S. dollar/Canadian dollar yet,” he said.

Others reckon that even if gains against the U.S. currency are limited, the Canadian dollar should still be able

to rise against other commodity currencies, such as the Australian and New Zealand dollars, given that the rally in crude oil prices outstrips the recent performance of commodity prices.

“The continued outperformance of oil versus base metals suggests the Australian dollar/Canadian dollar liquidation pressure will remain in place,” said BNP’s Redeker. ■

Virgin Takeover Talk

Continued from page 5

direction, corporate governance and management. Franklin Mutual, which has 30.3 million shares, or 9.4%, worth approximately \$797 million, also said it would seek talks with other holders.

Some of the thoughts analysts are circulating about the company include a potential buyer selling off parts of Virgin Media, such as the business-to-business telecoms arm and its cable channels, to partly fund a deal. Merrill Lynch analysts said in a recent report that the company could fetch as much as \$32 a share. In the absence of a takeover, Virgin Media's savings from the merger of Telewest and Virgin Mobile and the lack of taxes owing to its being unprofitable will help a buildup of cash, they said.

The company had GBP6.1 billion in debt as of March 31, which could be deemed as high given its market capitalization of \$8.6 billion, but fund managers in the name beg to differ. The New York hedge fund manager said that Virgin Media's debt level is at 4.5 times its estimated earnings before interest, tax, depreciation and amortization for the current year, compared with between six to eight times EBITDA for the average cable company.

"In today's market, that [debt level] is not a problem," said the other fund

manager based on the East Coast, which specializes in distressed securities. Like many other hedge funds, it got into the trade by owning debt issued by NTL, which emerged from Chapter 11 bankruptcy protection in 2002.

The largest hedge fund holder is **W.R. Huff Asset Management**, which had 16.1 million shares, or nearly 5% of Virgin Media's stock as of March 31. That stake, worth approximately \$423 million at current market prices, accounts for 41% of the equity portfolio of the value-investing hedge fund based in Morristown, N.J. The company is Huff's largest holding, ahead of another cable/media play, Time Warner Inc., which is a new name in the fund's portfolio, according to filings.

The firm, run by William Huff, was a key player in helping NTL exit from bankruptcy, but it has been reducing its stake in the re-branded company. It cut its stake to under 5% in January and sold 3.2 million shares during the first quarter. Huff's equity portfolio of just over \$1 billion is over 76% allocated to communications and cable and television companies, according to FactSet Research Systems Inc., which culls data from regulatory filings. Huff didn't return a call for comment.

New York-based multibillion-dollar **Glenview Capital Management** is the second-largest hedge fund holder in the

name, with a stake of 14.1 million shares that, unlike Huff's, grew in the first quarter of the year. Filings show that Glenview, run by Larry Robbins, added nearly 5 million shares to its Virgin Media position in the quarter, which is currently valued at around \$370 million. The firm has also been a longtime investor in the company.

SRM Global, a Monaco-based hedge fund launched last year by former UBS star-trader Jon Wood, had 13.3 million shares of Virgin Media as of March 31, or just over 4% of the company. The stake is worth nearly \$350 million and accounts for over 18% of SRM's equity portfolio of \$2 billion.

About one-third of Virgin Media's equity is in the hands of hedge funds, and some of the illustrious newcomers to the name include **Tudor Investment Corp.**, which bought 11.8 million shares currently worth \$310 million in the first quarter, and **OSS Capital Management**, which bought nearly 4.6 million shares worth \$121 million at current market prices. OSS didn't return a request to comment, and Tudor has a policy of not commenting on its portfolio.

Other hedge funds with sizable stakes each between \$180 million and \$210 million but that have been in the trade for over two years are **Pardus Capital Management**, **Highbridge Capital Management** and **Brahman Capital Corp.** ■

Nickel Demand Destruction

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100,000 tons this year, Macquarie said.

"Stainless steel demand is still strong, [but] it's reasonable to see a correction in nickel prices. Nickel prices have been too high for too long, so there will be a reaction, such as developing pig iron or using more scrap," said Macquarie.

Despite the substitution effort, the nickel market will stay relatively tight until 2010 as a result of growth in China's stainless steel sector, analysts said.

"Demand [for nickel] is still OK; there are no immediate signs of a pull-back," said a Singapore-based trader.

"Chinese stainless steel production appears to be running about double of last year's levels, and although Chinese mills are trying to switch as much production to low-nickel containing grades, this has not been enough to ease the current tightness," Macquarie said.

Citigroup predicts nickel demand growth at 6.8% this year, still strong after demand grew 11.8% last year. However, demand growth will slow to

3.1% next year, resulting in an expected surplus in the market, the bank said.

For 2008, Citigroup pegs average nickel prices at \$10 per pound, or \$22,040/ton.

Nickel's wild ride higher in the comparatively illiquid market to other LME traded metals adds to concerns of volatile price moves to the downside once sentiment turns bearish, analysts said. Speculative long position holders may find it hard to liquidate positions, resulting in potentially large intra-day trading ranges, they said. ■

Buffett, Icahn And Railroads

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railroads on top of a 10% stake in Burlington Northern, which the company first made public in April.

Berkshire now also owns 10.5 million shares of Union Pacific, representing about 4% in the stock of his Omaha neighbor, and 6.4 million shares in Norfolk Southern, or 1.6% of the Virginia-based operator.

The legendary value investor admits he came late to the sector, blindsided by a long-held aversion to the capital-intensive industry.

"I had this bias against them [railroads in general] for years. I was wrong," Buffett told Berkshire shareholders.

The Dow Jones/Wilshire index of railroad stocks has risen 30% in the last year. Investors such as Cascade Investment LLC, which manages personal investments for Microsoft Corp. co-founder Bill Gates, a friend of Buffett's, got in earlier and took part in that rally.

"What was a terrible business 30 years ago...will never be a sensational business," Buffett said. Still, he said, "the competitive position of railroads has improved somewhat."

Indeed, the industry last year probably closed the books on its best year ever, said Tom White, a spokesman for the Association of American Railroads, which compiles annual performance data for the sector.

Supporting their earnings, and perhaps tantalizing investors, have been several years of increased shipments of manufactured goods that get shipped from China and come through West Coast ports. Increasingly, trucking companies are putting these boxed goods on trains for part of their journey to the rest of the country.

U.S. container imports, for instance, increased by over 8% last year in volume. Production of coal, which

accounts for about 40% of rail freight volume and one-fifth of the big railroads' gross revenues, rose 2.6% to another annual record. And rail roads shipped more grain, helped by increased grain exports.

More demand has allowed rail operators to hike rates, increasing their ability to buy new cars, turnaround their once-poor service records, and ultimately, fatten their bottom lines.

"They are in a much better position financially than they have been in a while," said Ken Kremar, a capital goods and freight transportation analyst at Global Insight.

And while traffic has fallen this year because of the housing and auto downturn, analysts expect volumes to pick up as those sectors turn the corner.

After container imports slow to a 6.5% growth rate this year, Kremar sees import growth accelerating again to 7.8% next year. Manufacturing output excluding high-technology, another indicator of rail demand, is also likely to pick up again next year.

And some analysts say increased output of ethanol will also spur more use of trains, since nearly two-thirds of the corn-based gasoline substitute is shipped by train. In terms of traffic, "things look pretty decent for railroads" after this year, said Kremar.

Not everyone is convinced that the rail sector will avoid getting nabbed by a

downturn in the business cycle, however.

Larry Coats, a co-manager of the \$146 million-asset Oak Value Fund, follows Buffett's investing style and counts Berkshire Hathaway shares as the fund's top holding. But he decided not to buy rail shares.

"We don't tend to focus as much of our time on businesses that have short-term cyclical challenges or swings," said Coats, adding: "Mr. Buffett has the ability to have a very long time horizon."

On the other end of the investing spectrum, activist investors have been licking their lips over cash that rail companies have built up as business has improved.

CSX Corp., for instance, had a debt-to-assets ratio of just over 20% at the end of last year, or about half the debt levels for the average company in the S&P 500.

In filings, investment affiliates of Icahn disclosed a 2.7 million-share stake in CSX, representing 0.6% of the Jacksonville, Fla., company's outstanding shares.

And The Children's Investment Fund, commonly known as TCI, told regulators in March it planned to buy more than \$500 million shares in CSX.

TCI has been agitating for railroad companies to loosen up their cash holdings. Officials declined to comment but

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Hedge Fund Trades

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Buffett, Icahn And Railroads

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pointed to comments that TCI partner Snehil Amin made at a recent conference, when he said hedge funds needed to challenge management to boost shareholder returns, “because in many cases, the boards are unwilling to,” according to a Bloomberg article

That same day, CSX announced plans to purchase another \$1 billion in company stock, lifting its buyback program to \$3 billion, and said it would increase its quarterly dividend by 25%.

Although the move came at a time when CSX was pressured to do so, the company says the buyback plan resulted from its own annual review of its capital management strategy rather than calls from hedge funds.

“It’s more the focus on our strategy and continuing to deliver for our shareholders, as our track record has shown,” said spokesman Garrick Francis.

Icahn, whose funds also own a 29% stake in railcar-maker American Railcar Industries, did not return a call seeking comment.

The hedge funds’ interest is understandable, said one long-term holder in CSX, but it could go too far.

“I think they realize, if run correctly, railroads are most efficient and least-cost method of transporting goods across the country,” said Diane Jaffee, a portfolio manager for investment manager TCW. Funds she helps run started buying CSX at the end of 2000 in anticipation that new senior management could turn around the company’s poor operating performance and returns.

It has, boosting operating margins to over 20% and giving the company enough cash to reinvest in its business and return more to shareholders.

“Where I take exception with some of the activists is that they want all the cash right now,” said Jaffee, whose funds look for value stocks poised to become growth stocks. “If you take out all the cash flow and don’t reinvest in the business, where are you for the long term?” ■

Galloway/Stonepath

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time had offices in North America, Asia and Latin America. In 2005 the company reported a net loss of \$9.8 million on revenue of \$410 million. It has said it expects a “significant increase” in reported net loss for 2006. ■