

# The Equus Fund: A Different Animal

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By **Jason Van Steenwyk**

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Investor Spotlight



The Equus Fund is no ordinary closed-end fund. Rather, Equus is actually a private equity firm, dressed up to look like a CEF. But there are important distinctions to keep in mind.

Don't be looking to replicate any indexes with this fund. The fund's management stays clear of publicly-traded securities, preferring to enter into private equity and debt deals with privately-held companies. The target market value of these companies at the initial investment: \$15 to \$75 million.

Like the legendary Warren Buffett, the Equus Fund's managers seek to invest with companies with very strong cash flow, leadership positions or enduring competitive advantages within their market niches, a history of profitability, and with managers who still retain a substantial personal stake in the company.

## Investment Approach

Equus's management differs from the Warren Buffett style in that it does not profess to be a deep-value investment house. Instead, the Equus fund tends to follow a "growth at a reasonable price" strategy. Additionally, Equus has lately focused



on taking on promissory notes and senior securities that generate cash flow back to the fund, rather than embracing a buy and hold Buffett-style equity position. Furthermore, Equus doesn't go into a position planning on owning it forever. Instead, Equus goes in with an exit plan - often selling during an IPO or other liquidity event, in order to refocus on the micro-micro world of private equity.

And the investment is just the beginning. In addition to providing financing for expansion, the Equus fund stays actively involved in advising the company's management

- typically taking a seat on the board of directors, and providing company management with tools and consulting in a variety of areas. Occasionally, companies in the Equus fund's tightly-focused portfolio - 17 holdings at last count - need follow-on financing. If the prospects for profitability are there, so is Equus.

## Market Moves

It's been a difficult market for Equus. The liquidity crisis and economic malaise in the last few years have laid waste to many companies in the \$15 to \$75 million space, and severely cramped the margins of

◀ many more. But in some ways, the crisis represents opportunity for companies like Equus, who are able to step in and provide financing to promising companies which have been abandoned by more traditional funding sources. For example, last year, Equus managed to place promissory notes with a number of portfolio companies with interest rates of 15 percent, 17 percent and more.

### Expenses

The fund has also come under criticism for its expense ratio. Compared to conventional open-end and closed-end mutual funds, the expense ratio is rather lofty, at 6.58 percent. The comparison isn't valid, though. Most mutual fund managers take on little or no role in the company, and make no attempt to add value to the firms in their portfolio.

The Equus Fund is a different animal: When you account for the

active role that Equus managers take on in advising and assisting their portfolio companies in building strength and profitability, it's clear that Equus's expenses are more fairly compared with other venture cap, private equity and mezzanine capital firms. When compared on that basis, Equus's expense ratio makes much more sense, and compares much more favorably compared to other private equity firms of its size.

### Performance

It's been a challenging market for private equity firms in general. The IPO market was devastated in 2009, and with it the performance of many private equity-type companies. Equus took it on the chin, with everyone else, posting losses of over 20 percent in 2008, 2009 and 2010. The private equity realm seems to be stabilizing, however, and a resurgent IPO market is providing a light at the end of the tunnel for business development and private

equity companies like Equus who are looking for favorable opportunities to execute their exit plans. The fund is up 11 percent so far this year (as of May 20th).

### Outlook

Equus is currently trading at a discount of 37 percent to NAV. This reflects a substantial margin of safety, though investors should be aware that most of their holdings are very illiquid and extremely difficult to value. Nevertheless, the fund's holdings have a strong bias towards cash flow and debt offerings - making the substantial discount a distinct plus, especially considering the fund's success of late at negotiating favorable terms on cash-flow rich promissory notes. Continued stabilization in the IPO, mezzanine and private equity markets should help the fund's struggling equity positions catch up with the debt issues. As the economy recovers, Equus stands to shine. ■

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# China: Continued Slow Growth Ahead

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**T**he spectacular growth in the Chinese economy of the last decade seems to be settling down. The last two decades in China brought an expansion in economic power so broad and sustained that it spawned

a second industrial revolution in the country and transformed the nation from a regional agrarian economy into to a world manufacturing power with an immense middle class - all within a single generation. Broad swathes of coastal China would be unrecognizable to anyone who has been away over the last 20 years. And the world is taking bets on whether the Chinese will be able to engineer a soft landing.

Agnes Deng, portfolio manager of the Greater China Fund, continues to be bullish on the Chinese economy. Her outlook: China's economy will continue to grow, albeit at a more moderate and sustainable pace. She is projecting continued growth in the high single digits going forward - less than the spectacular rates of recent years, but still far outstripping the rates of growth in the debt-burdened West. Indeed, the monetary policy ▶

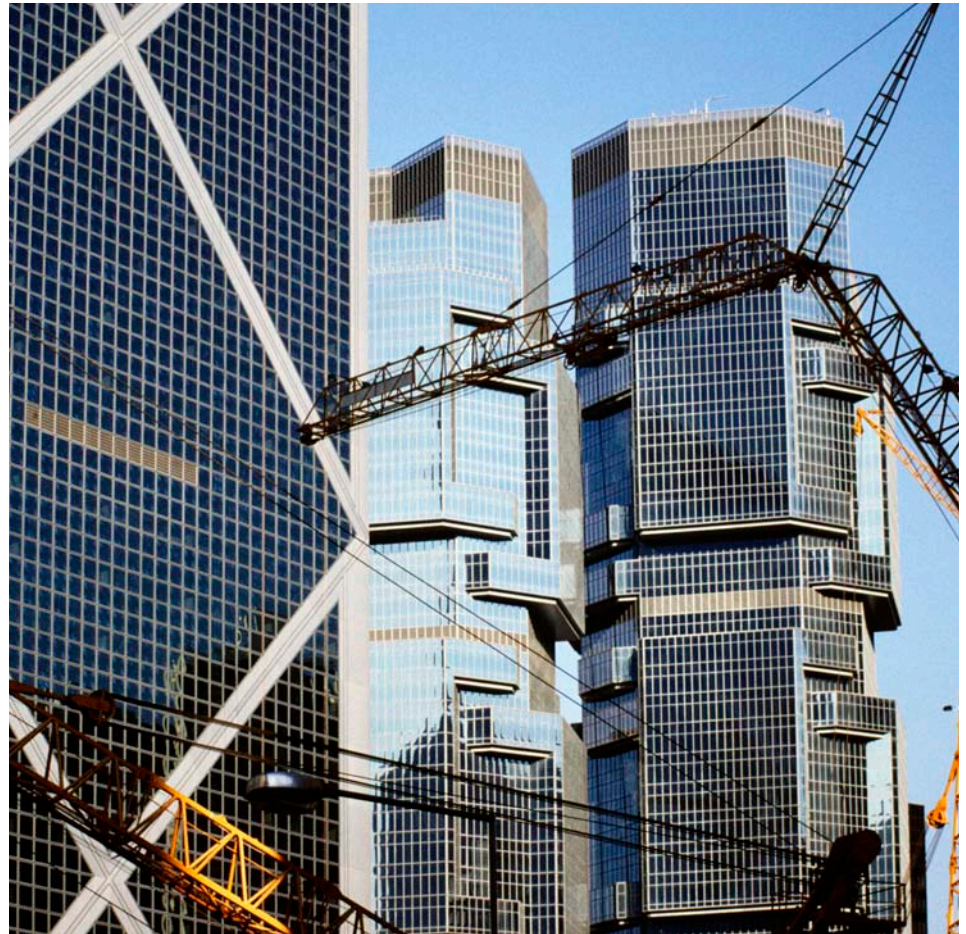
environment could become very favorable for Chinese investments in coming years. "We could get to a position where rates are flat or falling in China while still being tightened in the West," states Alasdair Anderson, Investment Communications manager for Barings Asset Management, the investment advisor company for the Greater China Fund.

### Savers vs Borrower Nations

The issues China faces are different than those faced by Western nations today. A net creditor nation like China has a much easier time engineering a soft landing than a net debtor nation, which must deal with a simultaneous collapse of tax revenues from business activity and substantial debt service payments. The prospect of spooking bond investors is a powerful constraint on debtor-nation's flexibility to deal with economic problems that arise.

The Chinese, in contrast, remain a country of obsessive savers. - They save up to 30 percent of their income, on average, across the board. So while a downturn in the US drives large numbers of overleveraged individuals into bankruptcy, even a substantial decline in economic activity has a 30 percent cushion before the Chinese consumer no longer has a choice about decreasing consumption.

The double-digit growth percentages of prior years cannot go on forever. Chinese banks pushed through the global recession by increasing the money supply by 29 percent, goosed bank lending by 32 percent and pushed through large stimulative public works projects to maintain economic growth. Meanwhile, China also began tightening its monetary policy well ahead of the Western economies. Deng believes that China may be



The Greater China Fund, consequently, has focused its holdings on consumer-driven sectors

nearing the end of its tightening cycle, having successfully engineered a soft landing. Chinese planners may be able to take their foot off the monetary brakes soon - which bodes very well for capital flows into Chinese equities.

### Middle Class Growth

Mr. A. Gary Shilling has argued recently in a Bloomberg column that Chinese wages have exploded to such a point that Chinese manufacturers are themselves looking to outsource production

to places like Viet Nam. But this is a feature, not a bug, according to Deng. Yes, China is moving up the manufacturing value chain. And as China's economy advances, it does become harder for them to compete purely on price. Yes, the low-cost provider niche goes to Vietnam, but that's not a problem for China, because modern Chinese manufacturing brings a lot more to the table than just cheap labor. Meanwhile, the rise in Chinese wages supports a huge domestic market for consumer goods. Higher wages, in this instance, are an argument for continued Chinese economic growth, not against it.

### Challenges

This is not to say that challenges don't exist, in China's future. They

◀ most certainly do. Chief among them is the possibility of a vast real estate bubble that has propelled property costs in some areas to Tokyo levels, and resulted in the construction of ghost cities of nearly uninhabited buildings. Chinese planners must also figure out how to keep the economy growing in the event that the West, including the United States, systemically reduces consumption, and by extension, Chinese exports. But from an investor's point of view, these issues can be mitigated somewhat by sidestepping the most threatened sectors.

### **The Consumer is King in China**

The Greater China Fund, consequently, has focused its holdings on consumer-driven sectors. For example, Deng has substantially overweighted positions in Chinese health care providers and related stocks. The theory - Once Chinese consumers have gotten a taste of modern health care, they are unlikely to give it up - even if they



make sacrifices elsewhere. Deng has also plussed up holdings in internet services - betting on the expansion of information access in the still-backward nation, and retail stocks.

"When the people start to have

increases in disposable incomes, there will be a change from an export-oriented economy towards the more domestic, demand-driven economy," Deng explains. Going forward, she expects to stick with that strategy as long as valuations in that sector remain reasonable.

### **The Factory Factor**

Deng has also maintained a solid exposure to manufacturers - this despite increasing pressures from cheaper competing labor markets in Viet Nam and Pakistan. Why? Chinese workers are getting more and more productive. Chinese factories have invested in technology and in a skilled and educated work force, compared to other Asian markets. That enables them to justify the higher wages and remain competitive.

Going forward, Deng intends to continue the consumer-focused theme, which she expects will be resilient, even in the event of further slowdowns among western economies. ■