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THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

Alternative Asset Management

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ALLEN R. GILLESPIE, CFA, is a Principal of GNI Capital, Inc., responsible for portfolio management and investment research for all of the company's managed assets, and he also serves as a South Carolina Retirement System Investment Commissioner. Mr. Gillespie authors an investment newsletter, *Supernova Stocks*, and contributes commentary to StreetInsight.com, a member of TheStreet.com's family of financial Websites that is dedicated to the institutional investor. Previously, Mr. Gillespie was a Registered Representative at Robinson-Humphrey and Smith Barney from 1995 until 1997. In 1997, he began managing private client portfolios, and founded and managed the Blue Ridge Total Return Fund, which was sold to the Colonial Trust Company in 1999. In addition to his advisory work, Mr. Gillespie provided independent research to a New York-based hedge fund. Mr. Gillespie graduated cum laude from Washington & Lee University with a Bachelor of Arts degree in Economics, and he has been granted the Chartered Financial Analyst designation. He is a member of the CFA Institute, the New York Society of Security Analysts, and serves as a Trustee and Chair of the Investment Committee for the Fifth Avenue Presbyterian Church in New York.

TWST: Would you tell us about GNI Capital and how it came into being?

Mr. Gillespie: GNI Capital is an alternative asset management firm. It was formed at the end of 1997 with the long-term view that the stock market might soon be entering a consolidation period, where returns would be lower than investors had previously experienced. With that market view in mind, we made the decision to focus on alternative strategies, because relatively flat markets are problematic for traditional asset allocation approaches, in which investors remain fully invested all the time. That might work just fine in expansionary cycles, when pretty much everything goes up, but historically such periods are followed by cycles where you have to be much more selective to profit.

We really believed that if we were, in fact, going into a consolidation period, a variety of alternative strategies were going to have to be used — the market just wouldn't be offering the same opportunities as it had during the previous market cycle.

TWST: What do you mean by an "alternative" strategy? Could you give us a few examples to explain the important elements of such a strategy?

Mr. Gillespie: For example, a style-rotating, go-anywhere approach is critical, because investment styles come in and out of favor, and it's important to remain nimble. We also decided that strategies that were less correlated to the broad market would fare better because the market wasn't likely to go anywhere. That translates into more concentrated portfolios. Finally, selective short selling and raising cash whenever necessary became key elements to our strategies. This alternative mindset was the framework upon which our firm was created.

TWST: How did you two get together to begin with?

Mr. Norton: The week after graduating from Tulane University, I moved up to New York and, a short time later, I was in the investment banking division of Smith Barney. That was a great experience, but my interest in the stock market was mounting, and I soon realized that I needed to be closer to the action.

After spending two years at Smith Barney, I made the jump to the buy side, where I was an Analyst at a hedge fund. I also began managing long/short equity accounts there — my first experience running money. I met Allen in 1998, on the trading desk of this hedge fund.

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Mr. Gillespie: I was there providing independent research, on a consulting basis, to this hedge fund, sharing office space while managing separate accounts for individual clients.

After graduating from Washington & Lee University, I started off at Robinson-Humphrey, which was later bought by Smith Barney. I left there in 1997 and went out on my own, setting up the firm that today is GNI Capital. I ended up moving to New York the following year, and Charles and I formally joined forces soon after that.

TWST: Along the way, I notice that you both earned the designation of CFA charterholder.

Mr. Norton: The Chartered Financial Analyst designation is recognized globally as the gold standard for the investment profession. It's a sign of professional excellence and integrity, qualities that are extremely important to us at GNI. And, importantly, the distinction is increasingly appreciated by investors worldwide.

TWST: Would you describe the various investment products that GNI offers?

Mr. Gillespie: Our money management services could be broken down into two categories: separate account management and commingled fund management.

On the separate account side, our two primary portfolios are the GNI All Cap Hedge Portfolio, which is long/short, and the GNI All Cap Portfolio, which is long-only. The long side of these two strategies is identical, incorporating our go-anywhere, style-rotating approach, concentrated stock picking, and varying market exposure – again, that's an alternative method to traditional separate account management that we believe is critical in a consolidation period. The long/short portfolio has periodic short exposure to the S&P 500, either by directly shorting the S&P 500 exchange traded fund, or by establishing a long position in one of the inverse S&P 500 exchange traded funds (ETFs). We launched both of these portfolios on January 1, 1999, and since their inception, both have substantially outperformed the market.

Other separate account strategies include a balanced portfolio and ETF-only portfolios. We also create specialized portfolios to help hedge the risk in single-stock accounts. If an investor has $1 million or more in one company, for example, we would work with him to develop a hedge strategy tailor-fitted to his personal objectives and constraints, which would help to mitigate that risk.

TWST: And on the fund management side?

Mr. Norton: On the commingled fund management side of the business, we run a quantitatively driven hedge fund. In addition, we are the subadvisor to two mutual funds (both with an alternative slant), and we are also the subadvisor to a fundamentally driven index product that weights its holdings based on aftertax profits.

We have a broad product offering, unified by a commitment to finding alternative ways to manage risk and generate profits for a diverse group of investors, regardless of market conditions.

TWST: You mentioned that the GNI All Cap Hedge Portfolio has periodic short exposure to the S&P 500, in some instances by way of a long position in the inverse ETF. What are inverse ETFs?

Mr. Norton: ProShares recently launched a set of ETFs that are inversely correlated to the major market indexes. There are four ETFs that are 100% inversely related — they move in the opposite direction of the underlying index — and there are also supercharged, 200% inversely related ETFs.

Mr. Gillespie: When the market goes down, these ETFs will go up in value. They are an especially great solution for investors with retirement accounts that prohibit short selling to be able to profit when the market drops. With these ETFs, we're now able to run our long/short strategy in retirement accounts.

TWST: How do you report and present your performance on the separate account side of your business? With many individual accounts, that seems like a daunting task.

Mr. Norton: Performance measurement is certainly a complicated issue. We've always been committed to the highest ethical standards and practices for our clients and prospective clients. So in late 2004, we began a rigorous, six-month process to bring our firm to the point where we could make a claim of compliance with the CFA Institute's Global Investment Performance Standards, the global benchmark in performance presentation. Being able to make a claim of compliance has increasingly provided a competitive edge for money managers, and we completed that process in March 2005. Now, our performance reporting since our firm's inception meets these high standards, and it's been verified by an objective, third-party consultant.

TWST: Would you explain your investment decision-making process?

Mr. Gillespie: Our analysis begins with a macro view from 30,000 feet. There are a variety of data points that we use to help us formulate that view, ranging from the term structure of interest rates and credit spreads, to earnings growth rates, to equity issuance and stock repurchases — and everything in between. The daily price and volume action in the major indexes is extremely important as well in determining our intermediate-term market view. Right now, our macro view is that we're about midway through a long-term consolidation period where equities are likely to return low-single digits per year. Since 1998, the S&P has returned only about 3% to 4% annually, and that is likely to be the norm for the next eight years or so.

TWST: And from there?

Mr. Gillespie: Once we have big picture view, we then work to determine what industry groups and individual companies stand to gain the most in that environment. We also like to have an identifiable catalyst that is just beginning to unfold — a new product launch, for example, or a geographic expansion, where a regional company expands nationally. Since our portfolios tend to be relatively concentrated, it's especially important that we understand the companies we invest in. This involves painstaking fundamental research and valuation work.

Mr. Norton: Our process begins top-down and ends bottom-up.

TWST: How do trades based on measurable calendar events fit in?

Mr. Norton: Event-driven trades tend to be more short- to intermediate-term, and we use them around the edges of our core strategy. Periodically, a special situation arises which is specific to one particular company — a restructuring, or a piece of regulatory news are two examples that come to mind. These measurable events cause a company's stock to become less correlated to the market and help us add incremental value from time to time.

TWST: Once you have gone through your process, how are the portfolios finally constructed? How many stocks will you own?

Mr. Norton: In our all-equity separate account portfolios, we typically hold anywhere from 10 to 20 positions, depending upon market conditions. In contrast to a lot of other managers, we utilize cash offensively; we aren't mandated to be fully invested all the time. If cash is the best available alternative, then we will have a high cash position. On the other hand, in a strong trending bull market, we might own 20 stocks and use margin where we can.

TWST: How much capital do you normally allocate to a new idea?

Mr. Norton: A typical position in our equity accounts starts with a 5% weight, and we will look for opportunities to build that up once it begins working in our favor. We're much more apt to add to a winning position than to average down.

TWST: Tell us about your risk management techniques that you employ in your actively managed equity portfolios.

Mr. Gillespie: For one, a certain amount of diversification reduces the total risk profile of our portfolios. Studies show that 90% of the maximum benefit of diversification can be achieved from portfolios of 12 to 18 stocks. With around 10 to 20 stocks in our equity portfolios, we've got a level that allows us to derive most of the advantages of diversification yet still remain somewhat concentrated.

Our willingness to raise cash, when it's the best alternative, is also a risk management tool. And selective short selling helps offset market risk.

Mr. Norton: We also tend to sell our losing positions first. No matter how much homework you do, the market is the ultimate judge of right and wrong. So when the market is telling us we're wrong, we listen. At GNI, we like to say that discipline trumps conviction. We try to remain objective and unemotional at all times.

TWST: How do you go about rebalancing your portfolios?

Mr. Gillespie: Our current holdings compete for capital with new ideas every day. If a better idea is found, an existing position is either reduced or eliminated. We'll also key off the stock's chart to try to identify climax tops, which occur after huge price moves, or a potential change of trend. A red flag on the chart could move us to the sidelines, making way for new ideas undergoing fresh breakouts.

The most important factor, though, is listening to the market. Most stocks move in the same direction as the broad market, so if we feel like it has peaked — when we start to see significant signs of institutional selling pressure, or distribution — then we'll look to raise cash aggressively.

TWST: Would you talk about your Profit-Weighted 100 Index Portfolio?

Mr. Gillespie: Fundamental-based indexing is one of the newer developments in the world of indexing. WisdomTree, backed by Michael Steinhardt and Jeremy Siegel, has launched a line of dividend-based index products, and there are others out there as well. Papers have been written in all of the major financial journals about the concept of weighting an index by fundamental criteria rather than market capitalization.

But the Profit-Weighted 100 Index Portfolio, launched in May 2003, was one of the very first of its kind. A gentleman by the name of Paul Wood created the concept, and we took it to a Pennsylvania-based trust company that ended up funding it. GNI is the subadvisor.

Mr. Norton: A trillion dollars is invested in or benchmarked to capitalization-based indexes like the S&P 500. The problem is that market value-weighted indexes tend to put extraordinary valuations on companies with shabby fundamentals or undervalue firms with first-rate financials. As a result, indexes weighted by market value tend to have the largest exposure to the most overvalued companies, and the least exposure to the more modestly valued ones. The Profit-Weighted 100 Index is an alternative, enhanced index product that uses the economically meaningful measure of pre-exceptional, aftertax profits as its principal weighting tool. In several research studies, this methodology has been shown to produce superior returns with lower volatility than a comparable market value weighted index.

TWST: Who are GNI's typical investors? Is it mostly individuals or institutional?

Mr. Norton: We built our firm by establishing direct relationships with high net worth investors. And that's still an important market for us that has grown mainly through referrals from existing clients. Now, we also have advisors who use our various products for their client base. Today our clients include high net worth investors, advisors, mutual funds, family offices, trust companies, and other institutional investors.

TWST: What is the investment climate like for your different products these days, and what is the outlook going forward?

Mr. Gillespie: We believe that stocks could return low single digits for the better part of the next decade, which is much less than the long-term average. Now, within that long-term period where the market is spinning its wheels, there will be major intermediate-term swings in either direction — multi-year, mini-bull and bear markets within a narrow, bigger picture range.

In that type of environment, it is important to have a dynamic, alternative approach, to be less correlated to the market, and to selectively raise cash. The process we use in our equity portfolios encompasses all of these elements, and there is strong demand for that at the moment. Hopefully, it will only continue to grow.

TWST: Thank you.

Note: Opinions and recommendations are as of 8/29/06.

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