Pine Creek Capital Management, AG Case Scenario

QUESTION HAS FOUR PARTS (A, B, C, D) FOR A TOTAL OF 20 MINUTES.

Pine Creek Capital Management, AG (PCCM) is a global multi-disciplinary investment management firm based in Switzerland. The firm invests across industries and regions, deploying capital in various asset classes including fixed-income securities, equities, real estate, etc. PCCM applies rigorous fundamentals-based research approaches to analyze cyclical and structural trends to achieve a strong risk-adjusted return. Jack Parson, CFA, a senior investment advisor at the firm, discusses equity returns with Angela Salazar, a research analyst at PCCM. He asks Salazar to estimate the returns for equities and bonds of an emerging market (EM) country. Salazar develops the projections for the EM country presented in Exhibit 1 below:

Exhibit 1

	Equities	Bonds
Volatility (σ_i)	20%	12%
Correlation with global market ($\rho_{i,M}$)	0.60	0.50
Degree of integration (φ)	0.65	0.65
Segmented market Sharpe ratio	0.28	0.20
Global Sharpe ratio	0.30	
Risk-free rate	6.50%	

Parson receives a call from one of his clients – MRC Groupe headquartered in Paris, interested in investing in office buildings in the eurozone. Annette Jones, CFO MRC Groupe, tells Parson that the holding company is keen to own high-quality office spaces that can be custom designed in prime locations across the region. Jones also wants to know the risk and rate of return if MRC considers owning small-to-medium-sized, standardized distribution facilities of consumer goods manufactured by eurozone companies. The facilities should be located near rapidly growing small population areas across the region. Parson obtains the following information from the research division of PCCM to estimate the expected return for office spaces over the next year.

Exhibit 2

Current Office Buildings capitalization rate (“cap” rate)	5.2%
Expected cap rate at the end of the period	5.0%
NOI growth rate (real)	2.0%
Inflation expectation	1.5%

A. Calculate i. the risk premium estimates for equities and bonds of the EM country using the Singer–Terhaar model and, ii. the expected return for equities and bonds.

(6 minutes)

B. i. **Identify** important characteristics of office spaces and distribution facilities that need to be considered in establishing a required rate of return for each potential investment.

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ii. **Calculate** the expected return from the office spaces based on the data provided in Exhibit 2.

(6 minutes)

Parson asks Salazar to suggest an emerging market country for investment where she foresees strengthening of the currency. Salazar shortlists two EM countries and collects the following information given in Exhibit 3.

Exhibit 3

	Wytan	**Nesia**
Expected inflation over next year	0.7%	3.0%
Short-term (1-month) government rate	decrease	increase
Expected (forward-looking) GDP growth over next year	2.0%	5.2%
Current account surplus (deficit) as a percent of GDP	11.60%	(2.6%)
National laws recently passed that enable foreign direct investment in real estate/financial companies	No	Yes

C. Based on each observation, **Identify** the country where Salazar would expect to see a strengthening of the currency.

(2 minutes)

PCCM is currently undergoing an adjustment in its global generic portfolio – Endurance, consisting mainly of equities and bonds. As part of macroeconomic based recommendations for Endurance to be presented in the upcoming investment committee meeting, Salazar is told to investigate the following countries for reallocation between equities/bonds. Salazar reviews the information given below:

Macroeconomic indicators	**Country X**	**Country Y**
Expected trend growth	decrease	increase
Global integration	highly integrated	rising integration
Expected business cycle phase	peak	trough
FX rate	likely to depreciate	likely to appreciate

D. Based on any two Macroeconomic indicators, **select** the country where allocation to equities should be increased, and bonds reduced. **Justify** your response.

(6 minutes)

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