

WEAK GROWTH, INSIDER SELLING, ACCOUNTING WOES
WHERE IS CROMPTON GREAVES HEADED?

OUTLOOK

Profit

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ITALY
WILL
MAKE
OR
BREAK
THE
EURO

EDWARD ALTMAN, INVENTOR OF
Z-METRICS, A SOVEREIGN DEFAULT
INDICATOR, SAYS THE EUROPEAN
CENTRAL BANK SHOULD PUT ASIDE
GREECE AND FOCUS ON FIXING THE
EUROZONE'S THIRD-BIGGEST ECONOMY

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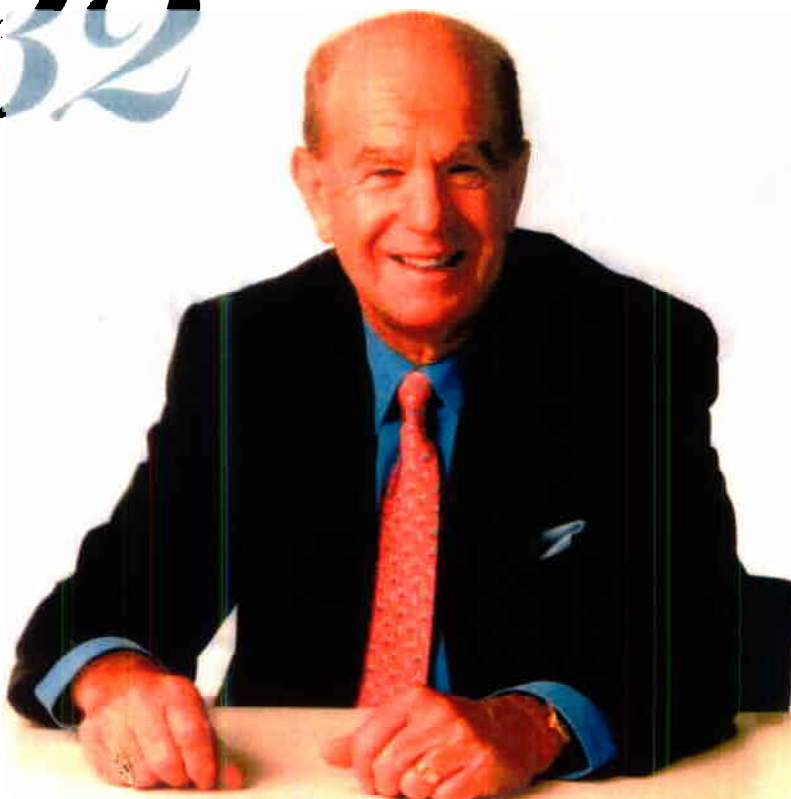
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Edward Altman feels the ECB should focus on fixing Italy, the Eurozone's third-biggest economy

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fees of Rs 34 crore for the first time in FY11. The sudden spike in capitalisation of these two intangible assets raises a vital question: is the company capitalising certain expenses to buttress its net income in a bad year? Another issue is the tax rates on overseas subsidiaries: the rate of income tax of Crompton's subsidiaries has been fluctuating – the rate rose from 26 per cent in FY08 to 35 per cent in FY09, and then came down sharply to 22 per cent in FY10 before climbing back to 25 per cent in FY11.

Subsidiaries hold four times longer inventory

The inventory held by subsidiaries has been calculated by deducting the inventory held by the standalone balance sheet from the figures in the consolidated balance sheet. The number of days of inventory held by subsidiaries is four times that

of the standalone entity.

Secondly, work-in-progress forms over 50 per cent of the inventory held by subsidiaries, raising questions of obsolete stocks or unfinished work due to cancelled orders. When *Outlook Profit* raised these questions with CFO Madhavacharya, he said that the first erratic performance of the subsidiaries and the tax rates were explainable only across the table (he was in Singapore when he spoke to us), but we could not investigate further for lack of time. As for the tax rates and inconsistent treatment of R&D expenses, he said that the "audited accounts of various subsidiaries are prepared as per the accounting standards of individual country and using these individual audited statements (prepared by PricewaterhouseCoopers), the local auditors consolidate." The fact remains that

Fluctuating taxes

(Rs)	FY08	FY09	FY10	FY11
PBT	129	253	317	305
Taxes	33	87	71	77
PAT	96	165	246	228
Tax/PAT (%)	26	35	22	25

Inventory pile-up

(Rs)	FY08	FY09	FY10	FY11
Stand-alone	263	281	303	405
Consolidated	1,066	1,095	1,041	1,189
Subsidiaries	803	814	738	784
Inventory days -stand-alone	34	32	31	36
Inventory days -subsidiaries	166	119	124	130
WIP-Consolidated	527	566	510	608
WIP-standalone	109	111	145	192
WIP-subsidiaries	418	455	365	416
% of WIP to total inv.-subsidiaries	52	56	49	53
% of WIP to total inv.-standalone	41	40	48	47

WIP: Work in progress.

Source: Company

since consolidated accounts are not prepared using the same accounting policy across all subsidiaries, the overall picture does seem distorted. Although the track

record of the global auditor does not reinstate much faith, one can probably give the benefit of doubt to the management for their visible business achievements.

That is the big picture. If we go by the list of downgrades and the cut in Crompton's target price, the stock is a 'hold' at best and 'sell' at worst. The justification for the sells are largely the quarterly performance challenges.

But then, there are other value creation levers embedded in the company that should not be ignored. Crompton owns 37.6 per cent stake (post issuance of equity by KKR) in Avantha Power, an associate company engaged in power generation. Going by the valuation of the last deal (KKR picked up 9 per cent in the company at Rs 217 crore) Crompton's investment is worth Rs 900 crore. Avantha will be looking to go public some time next year. And then, Crompton is still cash-rich with hard cash and liquid investments totalling to Rs 400 crore. That gives the company an option to go for a buy-back in case the market does not look up, although it may not want to exercise that option, since it will need the cash to pursue acquisitions imperative for its business. Another pertinent

point is that Crompton's acquisitions were made without raising equity even once in the past 10 years - all its purchases have been made in cash. That is commendable.

An all-important point that can't be overlooked is that HDFC Mutual and Franklin Templeton Mutual together with HDFC Standard Life hold a sizeable chunk (10 per cent) of the stock (HDFC has increased exposure during the recent mayhem). Although shareholder activism is conspicuous by its absence in India, these investors will carry more weight with the new management (Sudhir Trehan was a powerful force who turned around the company and, therefore, wielded a lot more authority). At a current price to earnings ratio of 13 times FY12 earnings, assuming a 10 per cent growth in sales and 9 per cent Ebitda margins, the stock seems worth a buy for investors willing to wait a couple of years at least. The current pessimism on the stock may offer better entry points. So, buy keeping aside scope for averaging on the downside. ■

It ain't o the fat lady

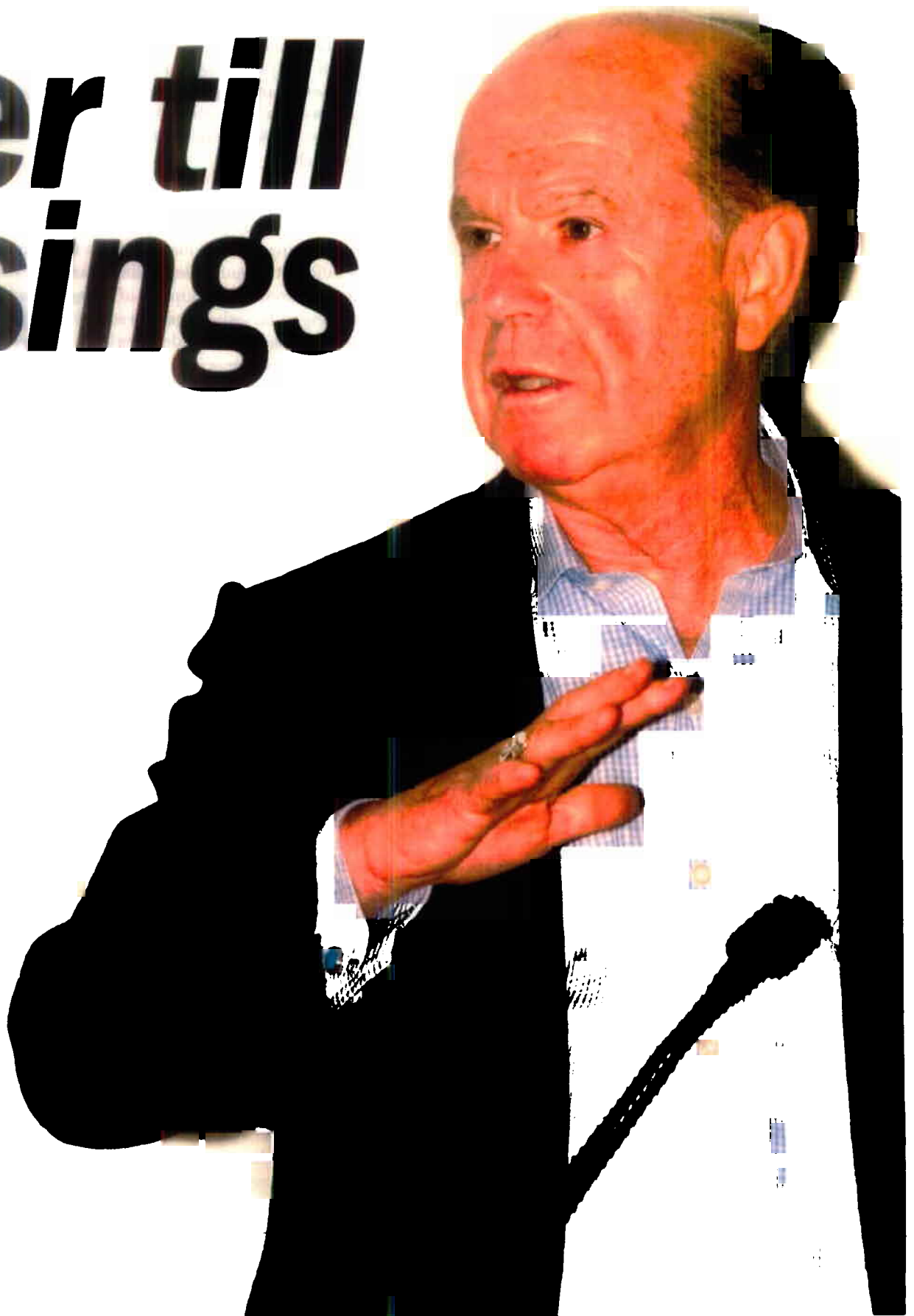


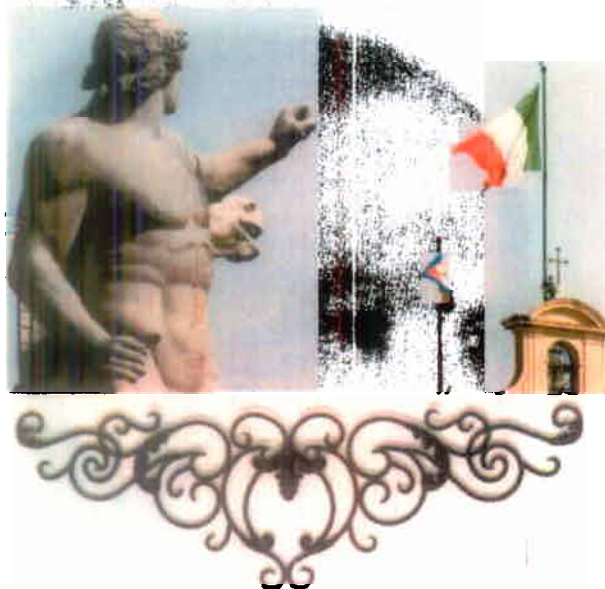
**EDWARD
ALTMAN,
INVENTOR OF
THE Z-SCORE
SAYS THE
"ITALIAN
DEBT OPERA
IS YET TO
CLIMAX**

*Rajesh
Padmashali*

The Greek Mathematician Archimedes sure had the makings of a hedge fund manager, just that he was a little ahead of his time. For it was he who famously remarked "Give me a lever long enough and a fulcrum on which to place it and I shall move the world." Move over Archimedes, the damage has been done. The current day politicians at Greece have already started to move the world, but in a not so pleasant way. The rumble has made its way through the rest of the Eurozone and has landed up at Italy. By the by, Silvio Berlusconi aside, Italy has a very colourful political history and for us Indians, Italy's most famous export is not pasta. But I digress. Since 1945 Italy has been a hotbed of political instability and has seen 61 governments in 66 years. Despite the Vatican being in the vicinity, the cardinal sin of fiscal profligacy flourished, and as a result today Italy's deficit is 120 per cent of GDP. The economy is slowing, the population is ageing and the politicians could be hoping to pass the buck to the ECB when bonds worth \$250 billion come up for refinancing in the months ahead. The trouble is, the ECB is busy rescuing the PIGS and Italy, being "too big to fail", it will have to conjure a miracle. Try this for size - Italy is a member of G8, the world's most developed economies, has a \$1.6 trillion GDP and is the world's third-largest sovereign bond issuer. Therefore, any murmur of its default or its inability to honour its financial obligations will jeopardise the future of the Euro, says Edward Altman, inventor of the Z-Score, a formula to predict bankruptcy risk of a company. Of late, Dr Altman has extended this to Z-Metrics which measures the possibility of sovereign default and he thinks Italy is the big elephant in the room that needs to be addressed. In this interview to Outlook Profit, Dr Altman highlights why he thinks Italy could be the villain or the hero in the ongoing European debt saga.

**ver till
sings**





The markets do not seem convinced with the results of the stress test released by the European Banking Authority which established that most European banks are just fine. What's your take?

First of all, many people think Greece will default, so I don't think the stress test factors in that default scenario. I think the banking authorities have mainly looked at recession and the effect of recession on bank capital rather than default by one or more Euro countries. There were three different commissions that were involved. But the point is I am not sure if they considered a default scenario, and even if they did was it just Greece or did they evaluate the extension of the debt crisis to other countries? To me, this signifies even Italy, although to many people that is unthinkable. In my opinion it is a non-trivial possibility. Any which ways, I am afraid there will be default from one or more European countries – it is a loss that will have to be incurred.

The big fear now is, if Greece defaults, what will be the contagion effect. That is number one. Number two is how much write-off will banks and financial institutions have to take. In the credit default swap (CDS) market, unless specified differently, the assumption is a 40 per cent recovery on bonds and a 50 per cent recovery on loans. That is a reasonable estimate for Greece. That means a 60 per cent loss if bonds are being held at par value and, I think, they are on the books of commercial banks, the European Central Bank and other investors. Assuming a 60 per cent loss for Greece, you have to factor in how much exposure each bank has and how much hit they would take on their capital. In my opinion, the

stress test should have included this and built scenarios for 20 per cent to 80 per cent loss. Then you have a full scenario analysis. How can you not include that in the stress analysis? That is a major criticism. But the commission is arguing that the data is all there for anyone who wants to do a stress test. They are leaving it to the market to decide instead of taking the responsibility themselves.

So you believe that the default of Greece is a certainty? It's not a certainty. Nothing is a certainty. I've been quoted as saying that it is inevitable but the word default has a different meaning depending upon who you are talking to. From the standpoint of rating agencies, they are talking so far only of ways to rescue countries and keep them going, which would be called as a selective default by the rating agencies. There is a lot of confusion in the newspapers, they ask – is the CDS market not signaling a default?

But it is not up to the rating agencies to determine whether there is going to be a default; it is up to an organisation called the ISDA. They are the professional organisation that regulates and manages the process for CDS. They may have a different criterion for default than the rating agencies. For example, in the United States now when a company restructures what is called a distressed exchange, it is no longer considered as default in the corporate CDS market. To me, it is defined by the ISDA, and they are keeping very quiet on what they mean by default, which may be different than the rating agencies. Now that doesn't mean that the banks may definitely have to write down the debt. If Standard & Poor for example calls it a SD (selective default), they might have to write it down. But even the rating agencies say this is only a temporary condition and once they restructure and the creditors agree on some new securities to replace the old ones including taking a haircut, then that SD will go away and they will be rated again as a triple C or even a B minus. So there is a lot of uncertainty about what default means.

What's clear, however, is that if they miss an interest payment or in the case of a company that goes bankrupt, that definitely is a default across all markets. So that is what the European Central Bank and the IMF will fight to make sure that they don't miss an interest payment. Then they will claim that it is not really a default. Even though this is a bit murky, it is clear that they are very sensitive to the rating agencies. The so-called French plan has up to now been scuttled because of what the rating agencies say will be considered as default. If they didn't, and let's say that it doesn't constitute a default in the CDS market, it still could be considered as a default in banking regulation. And they have also gone on record as saying that they will not accept the bonds that Greek

“The ECB and the IMF will fight to make sure that the affected countries don't miss an interest payment. Then they will claim that it is not really a default

banks hold of their own country as collateral anymore if it was considered as a default by the rating agencies. So then they could no longer lend money to Greece. What that translates into is that Greece defaults. In my opinion, that is what they need to do. Even though I am a professor and I am not unduly worried about policy making and the devastating effect that they are talking about in the market, I am worried about the fact that there doesn't seem to be any way for these countries to get out of this mess that they are into.

So how do you see this contagion playing out? Greece has no way out but to default on some of its loans. Banks will have to take a haircut, you prophesise that?

Well it has happened before. This time there is nothing new. When the Latin American countries restructured their debt, their banks, over 70 per cent of them, were hit. Part of it is the fact that you get new bonds that are not due for 30 years. May be you even fill coupons for which you don't get any interest for 30 years. The fact that you are deferring your interest, the present value of that makes less than it would have been if you got paid under normal circumstances. Secondly, you don't have to pay back that loan for a long time. So you issue new debt and I think that is what is going to happen. That has a much longer maturity similar to what the French were proposing. That still doesn't get to the fundamental problem and that is in many of these countries like Greece, Spain, Portugal and Italy, the economy is chronically non-competitive. None of these financial proposals address that structural issue. The only way to get to that issue is two mechanisms. One is a subsidy, obviously the government can't do it right now, but it will have to come from outside the government, for the enterprises in these countries to bolster their profitability and to make them more competitive. That involves not only a subsidy but also cutting costs. The second mechanism and I don't think they are mutually exclusive, is the devaluation of their currencies. And that is not possible; at least I haven't seen it constructively spoken about, if they remain a part of the Euro and the Euro bloc.

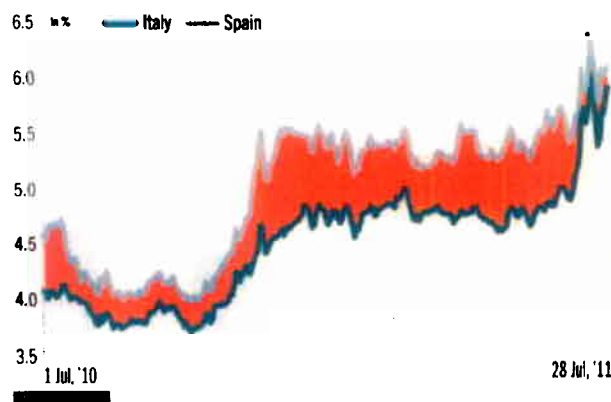
And so, when Argentina did it they uncoupled their relationship with the US dollar, as they were hampered

because their currency was pegged to the US dollar. They got out of that mess when their creditors took a hit and they devalued. I think that is the same medicine for Greece and probably for some other countries. That of course unless they have a creative way of doing it, may be by having two types of Euro, one international Euro that is only available for the stronger types of countries and the second is a more permissive type of Euro that can fluctuate.

I know it is easy for a professor to make this statement but when it comes to policy making you have to understand there is tremendous emotion and political capital involved. The other thing is that probably the only way it is going to happen is that if in the elections in each country people will vote for candidates who have policies which are different from the policies of the politicians who are in power. They will be thrown out by the elections and the new parties who will govern will say that we are not as committed to the Eurozone as these other politicians were. That will have to be unanimous which is not going to happen as long as Merkel and Sarkozy and some of the others are in power. They would see that as an admission of failure. Those are the two ways that have worked before - financial deregulation and currency devaluation. It could work albeit with some pain and some austerity measures on the part of the locals be-

Queue Jumper

Spain was seen as the next casualty of the contagion, but Italian debt yields have already hit a 14-year high



cause their currency is no longer as highly valued. They can't import stuff anymore as much as they could earlier and they have to cut down on their consumption. One of the reasons that they got into trouble was that they consumed far beyond their ability to pay.

Where does Italy fit into all this? In a worst-case scenario, does Italy have the potential to have a Lehman Brother's kind of impact worldwide?

My complementary measure for the health of the sovereign is the health of the private sector. One of the key variables in the health of the private sector is current market value of equities relative to its liabilities. That is the measure – probably the most important measure of all the other measures that are used in Z-Metrics. If the Italian stock market continues to deteriorate three per cent a day, it is not good but not bad either. A three per cent is only the beginning of the problem, but if goes down by 10 per cent or more, then the measure that I use also goes down by a large number. That is a screaming signal that the country is in further trouble than it now appears to be.

Getting back to your worst-case scenario, I don't think Italy will have that kind of effect because the surprise factor will not be there, as it was with Lehman. People didn't think that somebody of Lehman's size could go bankrupt. However that still means that tremendous hits have to be taken if Italy is to become like the others, by not only banks but other investors particularly the Italian banks and government institutions, which heavily funnel money into their federal budgets. Unfortunately when a country is earmarked or highlighted as a potential default country, then everybody does their homework a little bit more carefully and so the problems in the country become a little more heightened.

Earlier, my thinking was that Spain will be next dom-

ino (after Greece) but it wouldn't stop there. It would very likely spread to Italy which would then turn out to be the hero or the villain. But I was surprised, that it leap-frogged directly to Italy. If you look at the way the CDS market has moved, the two seem to move almost perfectly together. Actually, I am a little bit surprised that Italy's CDS hasn't jumped that much in the last week. But what has jumped a lot is the government bond yields. That is very important because of the huge amount of debt outstanding. I feel that Italy will be the key country, the so-called "fulcrum" country as to whether the Euro survives, regardless which one the markets focus on first. But, the Euro policy makers seem dead-set on avoiding a Greek default, which, in my opinion, is inevitable.

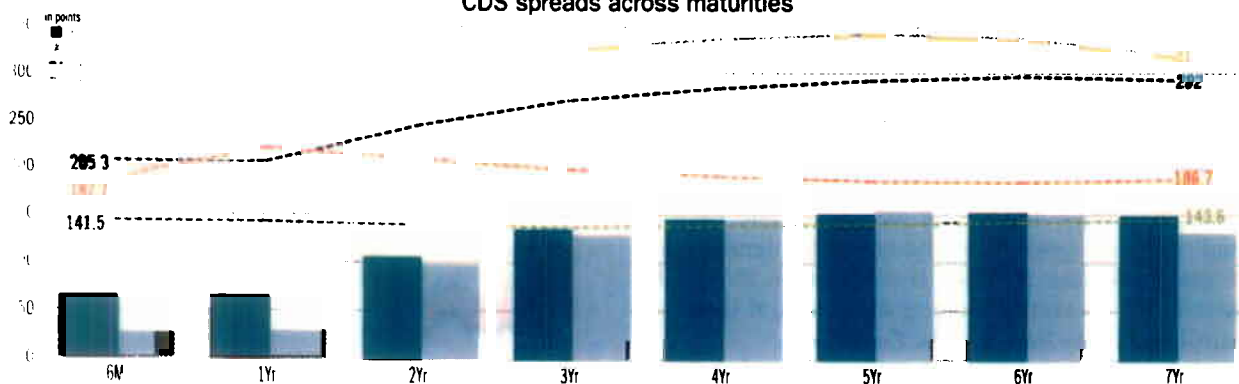
But the markets need to trust Italy. Since October last year Spain's 10-year yield has gone up from 4 per cent to around 6 per cent. Italy at the same time has moved from 3.7 per cent to 6 per cent. The markets are saying that look we will give you the money but the rates are going to go up. But can Italy afford this? Yes, Italy can probably afford 6, not 9. You would have to multiply that by the debt outstanding i.e. 3 trillion dollars. In terms of interest as a percentage of GDP, Italy is the second-worst country in Europe, second only to Greece. Of course, Italy's cost is far less compared to the 21 per cent that Greece has had to pay. So as long as they continue to roll over their debt, they can afford it. Having said that, this six per cent is when we are in a low interest rate environment. It is certainly not sustainable.

But the reason these interest rates are going up is because of the fear of defaults. If there is default, there will be no repayments...

Exactly, that is what will cause the problem. The fact that it is going up when people are still willing to buy the

Double Jeopardy

The market is wary of not only holding long-term Italian debt but short-term debt as well as seen in the increasing CDS spreads across maturities



“ We should not underestimate hedge funds who see an opening in an attack on Italy. They have created very large short positions through the derivatives market

debt at 6 per cent now instead of 3.7 means that in the final analysis they don't believe there will be a default. I think that they are weighing all the pros and cons. But you are right. The higher the interest rate, the higher the likelihood of default. Right now, I am thinking that the probability of default in the next five years for Italy is probably in the 20-25 per cent range. That is echoed by the US market. That means there is 75 per cent likelihood that there won't be a default. So, if you are an investor you multiply your interest rate that you get by 75 per cent and then you compare that with 0.8 times 6 per cent. Multiply by 0.2 per cent the loss and I think in Italy the loss will be much lower than Greece. In which case, probably the interest rates will have to go up a bit higher. About 7 per cent interest rate will be the equilibrium. That is one way to look at the expected value, without factoring in the probability of the outcome. Also, there are a lot of variants around that expected value.

Another aspect that we should not underestimate is the importance of hedge funds and other investors who see an opening in an attack on Italy. They have hedged very large short positions mainly through the derivatives market. Additionally, Italy too has a political problem which the markets see as a weakness that could exacerbate the problem. So, interest rates go up, the spreads go up and then they fall back. There is a reversal in the interest rates and the spread. This is strictly a technical reversal not a fundamental one. It is just like the stock market - when you see a company in trouble, you short it and take advantage of its short term vulnerability, then you get out of it and by the simple laws of supply and demand, price goes back in the other direction and people think the worst is over. Things reverse themselves and people believe that the problem is overblown. Then, in the short run they are misled by these big fluctuations in interest rates and stock prices.

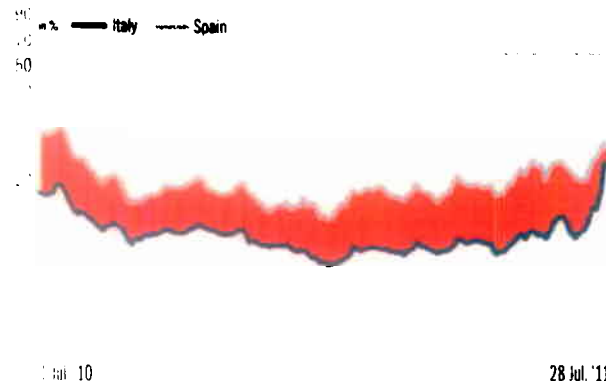
But when you are faced with something the size of Italy and you have hedge funds driving spreads up, wouldn't that have a vicious effect breaking the confidence of people holding those bonds?

Absolutely. There is no question that the speculative movement will make it much more difficult and that is



Haircut season

The CDS market is pricing in a 20 per cent default probability for Italy and closer to 25 per cent for Spain



why you often find the central banks buying when people are actually selling to keep the prices stable. You are absolutely right. This is a big concern. There is one issue the US Fed is concerned with and that is who is writing the CDS contract. I hear that US insurance and banking firms are the biggest writers of CDS contracts. In that case if there is a default, those institutions will take a hit and I am sure that there are Fed officials are calculating or trying to get that information. So they will know which banks are most vulnerable to a European country default.

Coming to the CDS market, is it a very effective market because you have got banks underwriting CDS', you have got naked CDS' being written without the ability to back that up. In case of a default, that doesn't make for a good scenario, right?

It is a bad scenario and a worse scenario for the naked situation. There is no benefit to anybody, except for the speculator. In a default, you are not hedging against the contract. A good question that you bring up and I don't know the answer to is how many of those creditors and others are actually hedging in the CDS market. I believe that if there is a default in Greece, the French are the most exposed foreign country. How much of their expo-

sure is mitigated by the CDS market? If it is mainly naked CDS, then these folks are not going to be hit by the default the most. There is little hedging in that. If there is significant hedging, specifically by the German and the French banks, then maybe all this concern is not such a great concern as long as the default is not a CDS default. That is the upside or the downside, if you will, of the CDS markets impact on this situation. I don't know if the CDS writers are capitalised enough to honour their commitments. I think most banks are if it is just Greece. If it spreads to Spain and Italy there will be a big problem.

Is Italy too big to fail?

That's a great question. The other way to frame that question is that is the euro so important, that it will overwhelm economic rationale and I think the answer to that is no. I think Italy is not too big to fail if the world is willing to live with a non Euro-centric union. If the answer is, from the standpoint of politics as it's been up to now that save the Euro at any cost then it is anybody's guess. But not when it comes to Italy or oddly enough even Greece. Greece is too big to fail because of the contagion effect. In the end, they will come up with some solution that will mean the non-competitive countries will lead the Euro. Italy could be one of them. Yet, I want to emphasize that I think in the final analysis Italy will not default. It will be strong enough to withstand the attack and that it will turn out to be the hero. But the chance is non-trivial.

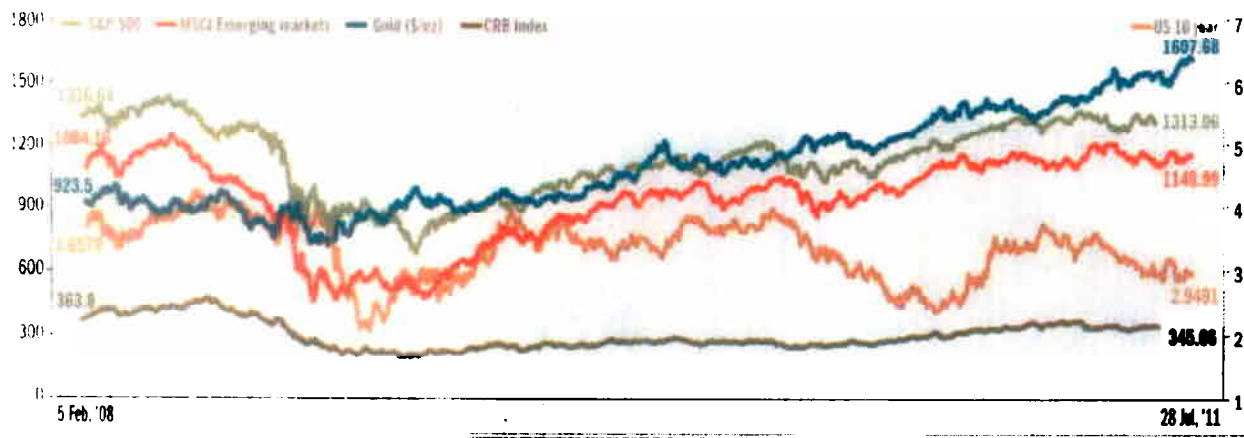
What's your take on the financial health/creditworthiness of India compared with other countries?

One metric to look at is the debt level of the country and its ability to borrow relative to the size of the economy. India doesn't have any foreign currency government debt. So I ran my model on the private sector, and this was at the end of 2010. By the end of 2010, the average median probability of default by Indian companies was relatively low but higher than countries like the United States, Germany and a few others. It was better than most European countries but not as strong as say Singapore and Hong Kong. I wouldn't be concerned about

“I think Italy is not too big to fail if the world is willing to live with a non-Euro union. If the answer is from the standpoint of politics then it is anybody's guess

Giddy climb

Post the credit crisis of 2008, all assets resumed their upward march to the beat of overwhelming liquidity



India because it has a healthy private sector and because its level of foreign debt is relatively small.

Why is it that most “experts” were blindsided by the credit crunch of 2008? Have we learnt anything since then?

Well, that is not true. I think a number of people saw it coming. It was more about psychology. By the way I was one of the first people who said the credit bubble would burst. I lectured about it in 2006 and wrote about it in 2007. I was concerned about the huge pile-up in corporate debt. I didn't concentrate on the initial part of it which was the securities market. In fact, at the end of one such lecture to a very large North American banking audience, the president of a bank took me aside and said, “That was very convincing. If I follow you what you say is going to happen then I should be reducing my exposure and possibly even shorting the credit market.” He, however, said that he didn't have the courage to do that. I asked him, what he meant by courage. He replied, “If I am right, the market will have serious problems and credit will be much more expensive. In turn, I will be a hero and get a big bonus. If I am wrong and the music keeps playing, credit will become cheap and banks/institutions will keep lending to the trading desk. If that happens, I would lose my job. To me it is more important to keep my job than to be a hero.” I think it was more this sort of thing that was going on and was one of the reasons why the crisis happened. The other reason was the misplaced belief in rating agencies that they were doing the job for them. This is the reason why I was particularly concerned that the European banks were not put through the true scenario test. That is the same thing that happened to the mortgage-backed securities crisis - the downside of the real estate situation was not considered. One of the concerns that I have today is that the recovery from the

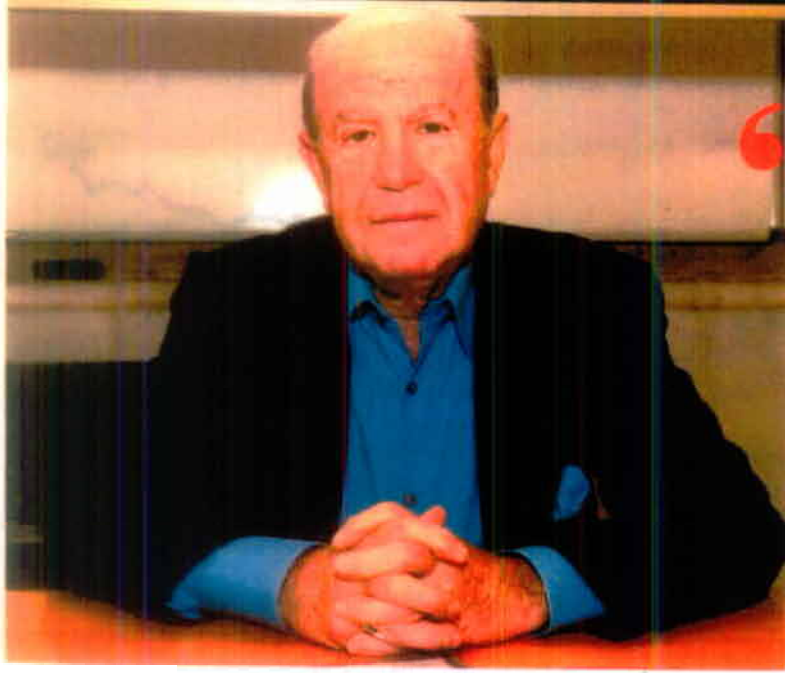
crisis was too fast and too furious. Except for the derivatives market, we have forgotten the lesson that too much debt led to the crisis in the first place.

You first developed the Z-score for manufacturing companies, what were the challenges in terms of trying to replicate the same for the financial sector?

The main challenge came from the fact that the events and circumstances which land financial institutions in trouble are very different from those faced by other industries. So, it is very hard to use historic data to build these models. The other thing was that while I was building my models for companies there were others who were trying to build models for banks. They didn't succeed. I said to myself: they were very smart people in the banking sector who failed in the attempt. Why should I try? Finally, I realised that it was very important to try and build a banking model because many of the countries which get into trouble, Ireland in particular, do so mainly because of the banking sector. So, we now have a new model on banks to add to the Z-Metrics approach. Now we take a weighted average of the health of the private sector, which includes both banks and non-banks. That was the reason why it took me a long time to get interested in a banking model. But now I realise that you can't avoid it.

Where do you see risk residing now? Any particular risks that banks or financial companies need to prepare themselves for?

I think the three main risks are US municipal bonds, US government debt and resurgence in highly leveraged transactions, besides the sluggish economy. The two main risk areas for banks and for markets, in general, are the very slow growth in developed countries and the survival of the euro. In fact, the very high correlation between



“The high correlation between stock and bond price movements over the past four years, indicate that there is no place to hide

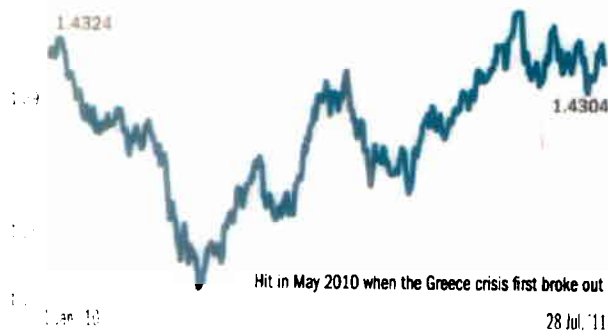
stock price movement and bond price movement over the past four years, indicate that there is no place to hide.

Gold used to be talked about as a safe haven against the dollar. Is the dollar still not the pre-eminent currency safe-haven given the current Euro crisis?

By the way the dollar is not going up. It is more or less stable. It is not going down either as much as you would have thought. I am on the board of Paulson & Company; we have always felt that gold is a very good hedge not against inflation but also as a currency hedge in case the dollar fluctuates. Interestingly enough, as you point out, gold has gone up not because the dollar has gone down. Gold has gone up because of not just the general feeling

Uncle Sam calling

Despite its warts, the dollar is the ultimate safe haven currency, as could be proven in case of a Italian default



of uncertainty in the world but because it is a safe haven psychologically. Secondly there is this perception that the US dollar will go down rather than what has actually happened. As a hedge against the US currency devaluation gold still has that attribute even though so far it hasn't happened. The two haven't gone in opposite directions as you would expect. It is more expectations as opposed to what is actually happening.

Can you tell us something about your work at the InterSchool Orchestras (ISO) of New York? Do you play any instrument yourself?

I do not play an instrument but my son plays the French horn and I got interested in classical music mainly through his playing and somehow got drafted by the ISO board to help out and eventually I became chairman of the board. The ISO is now going to celebrate its 40th year and I have been involved with the ISO board for the past 20 years. I love the fact that music education plays a great role in stimulating young people to not only play music but playing as a team and working together and getting disciplined in their circles and processes and is a great teacher for the rest of the world. I wish there were more subsidies and benefits for music education and the level of young children.

Having seen, experienced and achieved so much, are you of the belief that all change is for the better?

No...of course not. Many times a change happens; it is the result of a crisis. Certain change is necessary at certain times, in some circumstances, but I do not believe that all change is for the better. □