ONE STEP AHEAD

Private equity and hedge funds after the global financial crisis

Timothy Spangler
For my wife, who only after a few years of marriage realized the important difference between a hedge fund lawyer and a hedge fund manager, and for any young women of marriageable age today who consider this distinction significant
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ONE STEP AHEAD
As a result of the global financial crisis, much ill feeling remains toward Wall Street, the investment banks and those individuals who profit from short-term movements in the financial markets. As the crisis dragged on into 2013, more questions are being raised about how the modern financial system actually works. Identifying “who does what” when it comes to complex derivative securities or the take-over of well-established, brand name companies by faceless financiers seems much more difficult today than a generation ago.

Over the last decade, hedge funds and private equity funds have entered the mainstream public consciousness after many years of profitably operating in the arcane shadows of the economy. Although originally developed in the United States, these funds quickly expanded across the Atlantic to establish a base of operation in London. As they become more and more successful, their techniques, tools and structures rapidly spread to financial centers around the world.

The financial meltdown that commenced in earnest during the autumn of 2008 soon led many observers, commentators and regulators to question more closely what it is that private equity and hedge funds actually do. Many of the concerns that were identified, though, require a deeper understanding of the structure and operation of these funds in order to properly evaluate them. Without this broader context, effective criticism simply isn’t possible.
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In a single weekend in October 2011, however, protesters inspired by the Occupy Wall Street movement held demonstrations in over 900 cities around the world. Their goal was to draw attention to corporate greed and massive cuts in government spending. Images of these protests filled television screens and social media websites for the weeks that followed.

Unfortunately, the lingering financial crisis is about more than just greed. This is why it has been so difficult to understand precisely what is broken and how it can actually be fixed. But talking about greed, and making signs about greed and chanting slogans about greed is much easier and much more compelling than actually trying to understand the complex web of linkages between monetary policy and asset values, or how best to oversee the diverse operations of cross-border financial conglomerates, let alone how nimble, entrepreneurial financial firms such as hedge funds and private equity funds are able to earn the eye-watering profits that they do.

Marching behind a banner that says, “We demand the forgiveness of all debts,” has a certain rhetorical conciseness, even if it is an utterly impossible and unattainable goal.

After two years of Tea Party protests in the United States that tapped into popular anger at excessive government borrowing and spending that appeared fatally out of control, the Occupy movement demonstrated that popular anger could also be marshalled by the Left to attack Wall Street and the global financial infrastructure, even if only for a limited period of time.

While the thrust of the Occupy movement was to attempt a critique of the economic superstructure within which we live, the focus of the earlier Tea Party movement was to voice concern over a government that has grown morbidly obese and ineffective on high taxes and incompetent bureaucrats unable to adequately address the mounting problems that the country faces.

These two points are not mutually exclusive.

Americans and Britons were notably quiet in the initial months after the financial crisis first made itself known in autumn 2008.
Despite the near collapse of many parts of the international financial system, and unprecedented levels of governmental intervention into Western economies, for many the events on Wall Street and in the City of London were far removed from their day-to-day lives. It took until 2010 for the Tea Party to gain sufficient momentum in the United States to break through into the public consciousness and until 2011 for the Occupy movement to enter the public stage.

Millions of people are angry, and many millions more are simply frustrated. At the beginning of 2012, it was estimated that over 20 percent of US residential mortgages were under water and almost 15 percent of Americans use food stamp benefits. Statistics in Britain and other European countries were equally bleak. As their attentions turn to out-of-touch governments and moneyed elite that they find hard to understand, Americans and Britons and millions of others are beginning to ask questions about a new generation of independent money managers who have established themselves as key players in the financial markets over the past four decades.

Walk down Fifth Avenue or Knightsbridge in 2013 and it is imminently clear that some people, at least, are still doing very well despite the economic upheaval. As a result, the focus on private equity and hedge funds continues to intensify. Unfortunately, many people still lack a deeper and more nuanced understanding of these funds really do, and why.

A general public that no longer trusts business and finance will have tremendous difficulties relating to the sponsors and managers of private equity and hedge funds. These individuals operate in niche areas of finance that intersect with traditional investment banking and commercial banking firms, but their mandates differ significantly from stock brokers, securities underwriters, mergers and acquisition (M&A) advisers and mortgage lenders.

The role of investment advisers and fund managers has been an established part of the world of finance for centuries. In that regard,
private equity and hedge funds are clearly not unprecedented. They are not a recent phenomenon. Those with money have long recognized that the fact they amassed significant sums in the past is no guarantee that they have the knowledge and acumen to invest it wisely and effectively in the future. As a result, talented individuals have long established themselves as trusted advisers who can assist in selecting the best use for these pools of capital, which can provide for lucrative investment returns while at the same time seeking to maintain some level of security for the capital.

In fact, since the end of World War II, retail investment funds have replaced direct stock market investments as the most important way in which “Mom and Pop” investors access the securities markets. Known as “mutual funds” in the United States, “unit trusts” in the United Kingdom and “UCITS funds” in Europe, these retail funds now comprise an important part of many families’ retirement savings.

In the simplest terms, private equity and hedge funds can be seen as different species of this same genus of “investment funds.” Unlike retail funds, however, these funds are limited by law to sophisticated, non-retail investors. Uncle Edgar in Topeka or Aunt Edna in Balham is prohibited by their respective governments from putting their savings in these vehicles because the risk is deemed to be too high. These funds are, therefore, strictly off limits.

The sustained success of private equity and hedge funds in the last two decades, however, has led to more and more coverage of their investment activities in the mainstream press. As a result, more and more questions are now being asked about what they do, how they do it and why they have been largely free from direct regulation in the past.

Despite the passage of five years, we are still coming to terms with the events of 2008, and few consensuses exist on either their causes or their long-term effects. Given the increased prominence of private equity and hedge funds recently, it is wholly unsurprising that critics are now turning their attention to these “alternative”
investment funds. Too often, however, the drive to further regulate these funds and limit their potential scope of operation is occurring in a vacuum devoid of detailed knowledge of their structure and evolution.

The first thing that strikes you now when you re-read the “Declaration” issued in autumn 2011 by the Occupy protestors assembled in Zuccotti Park in downtown Manhattan is how little of it actually relates to Wall Street. Many of the “demands” inserted into the manifesto drafted by the various grassroots organizations behind the protest have no relation to how Wall Street functions, or to the issues that have arose since the Credit Crunch led America (and much of the developed world) into this Great Recession.

Following the age-old agit-prop dictum that no good popular uprising should go to waste, it seems that a variety of other concerns, such as student loans, public employee pensions, animal rights and genetically modified food, were the principal concerns of many well-intentioned Occupiers. The complexities and intricacies of Wall Street and the City of London were largely ignored, except for a few cursory statements about bank bailouts and excessive compensation that have been stapled on to their wish list.

The initial choice of venue – the financial district in Manhattan – gave the protestors a chance to air their long-standing grievances in a location imbued with deep significance. But frustratingly little of what was said, sung, chanted and painted on signs was actually directed at the way the global financial systems currently operate and how these practices could be improved. Few men and women who work on Wall Street or in the City of London would make the claim that modern financial markets have achieved some variant of divine perfection. These markets exist as a result of human endeavors and, as a result, they are subject to human frailties and flaws. There is always room for improvements.

The possibility that a generation of students and young people would remember for the rest of their lives the personal misery
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and frustration that has arisen in the last five years due to the near-collapse of our financial markets is actually very encouraging. As citizens and savers, we each have a responsibility to ourselves, our families and our country to have an opinion on the current state of our financial system and its regulation – even when the details of credit default swaps and high yield bonds lead to fits of sudden-onset narcolepsy!

Ultimately, though, an attempt at a direct and informed critique of the operation of the global financial system generally, and the role of private equity and hedge funds specifically, was frustratingly absent from the Occupy demonstrations.

The process of connecting savers with borrowers, and providers of capital with users of capital, requires intermediation. This need for intermediates creates a need for savings banks, stock markets, brokerage firms, mutual funds and investment banks. Otherwise, it would be impossible to put Uncle Edgar’s or Aunt Edna’s pension contributions into the hand of the corporate treasurers of either Apple or Facebook, or the public coffers of various local, state and federal agencies who fund their operations with regular bond issuances.

Without such intermediaries, Uncle Edgar’s or Aunt Edna’s money would remain in an old coffee tin, where it would slowly lose its buying power when faced with the steady erosion of inflation. Simple laws of financial thermodynamics are at work all around us. Money at rest loses value over time. Money in motion provides the possibility of gains in excess of inflation, but also the risk of potential losses.

What we call “Wall Street” is a significant component of this intermediation infrastructure. Unless we move away from a monetized economy, and opt in favor of bartering on a scale never seen before, then the intermediaries must remain. The question then becomes what to do with these intermediaries, and the risks they pose to the rest of us.
The financial markets require regulation. Thousands of government employees around the world have as their direct responsibility the policing of banks and stock brokers and hedge fund managers and pension trustees in their countries. The adoption in the United States of the Dodd-Frank Wall Street Reform and Consumer Protection Act (known as “Dodd-Frank”) in 2010 and the ongoing restructuring of the financial regulatory regime in the United Kingdom demonstrate that more needed to be done to keep the level regulation up to date to a rapidly evolving industry. Today, however, it remains unclear what the net effect of these numerous changes and “improvements” will actually be.

There will always be valid criticism that can be made about any industry, and Wall Street is certainly no exception. To the extent that the demonstrators in Zuccotti Park would have coalesced around a few convincing compelling themes directly relevant to improving the financial infrastructure and ensuring that Wall Street is successful at spurring economic growth for the United States and its citizens (as well as in other developed and developing countries around the world), then they could very well have had a meaningful and lasting impact.

Since the Occupiers’ demands remained frustratingly vague and ambiguous, distracted by an amorphous assault on rhetorical bogeymen and unable to propose clear and specific criticisms, then it was always highly unlikely that they would have anything like the impact that they desired and deserved.

Just “wanting change” is never enough.

The Occupy movement, however, was simply the most public display of concern and hatred that remains widespread to this day.

For example, in the autumn of 2011, a group of students at Yale University turned up at a recruitment event for the leading Wall Street investment bank, Morgan Stanley, which was being held near their campus. They were not dressed in blue power suits, tastefully complemented by a Hermes tie or a single string of
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Mikimoto pearls. Instead, their purpose was to protest alleged Wall Street improprieties, and to encourage their fellow students to seek employment opportunities elsewhere. Despite the protesters’ sincere and heart-felt pleas, the eager job applicants assembled in New Haven that evening were simply following in the footsteps of countless prior Yale alumni who did exceedingly well on Wall Street, including, among others, Steve Schwarzman, the founder of private equity titan Blackstone Group.

Emotions were so high at this time that some critics even went so far as to compare these recruitment events, which brought leading investment banks and financial firms to leading universities, to on-campus recruitment during the Vietnam War by the American military, in the form of Reserve Officers’ Training Corp programs. The willingness to make such comparisons demonstrates how dramatically perceptions of the financial industry have changed since the global financial crisis began. Indifference and ignorance has for many been replaced by suspicion and anger. Around the same time, at Stanford University, an online campaign entitled “Stop the Brain Drain” sought to convince students that they should say no to the “dark side” of lucrative careers in high finance.

If Wall Street (and the private equity and hedge funds that have evolved in recent years) in fact depends on human capital as much as financial capital, as many of its champions have claimed over the years, then a lack of the best and brightest young men and women could eventually suck the oxygen out of the financial markets.

But where else would these talented, numerate and highly competitive graduates actually go?

It is easy to talk about the contest between “Wall Street” and “Main Street.” It is a simple analogy and like most simple analogies, it can be very compelling.

When we witness a catastrophic event, like the collapse of Lehman Brothers in September 2008 at the virtual epicenter of the global financial crisis, there is an deep-seated instinct to see those
events as occurring in a completely different system of rules and concepts and language than what applies in your own neighborhood to a family desperately trying to refinance their home or a small business owner attempting to fund expansion at a time when her competitors are gobbling up market share.

But they are related in an intricate and insoluble way.

It is an oversimplification to say that Wall Street must exist for the purpose of serving Main Street. The problems that Main Street faces could be solved locally, without recourse to the financial markets that Wall Street and other financial centers orchestrate. Investors, savers, borrowers and issuers turn to these financial centers because they are in search of returns that are higher, or financings that are less expensive, than they can obtain in their own local communities.

Operating as a middleman, investment banks earn lucrative profits by matchmaking investors with potential investments. As more money is funneled into the financial markets, there are more opportunities to trade in these investments and earn further profits based on which way the market moves over the short, medium and long term. Private equity and hedge funds are formed to identify and profit from precisely these opportunities.

After the early, and most spectacular, failures produced by the global financial crisis began to recede in our memories, the public conversation eventually returned to the concept of “fairness.” In particular, more and more of the debate seemed to focus on a perceived lack of fairness in the context of excessive pay being earned on those operating at the highest rung of the financial services industries. Politicians on the Left, for example, have never been especially reluctant to play the fairness card when in search of further tax revenue, and the tax increase brokered in the closing days of 2012 between President Barack Obama and the US Congress was driven primarily by this desire for a “fairer” allocation of tax burden.

The great linguistic contribution of the Occupy Wall Street movement – and perhaps its only lasting contribution – was mainstreaming the propaganda terms “the one percent” and “the
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ninety-nine percent.” On both sides of the Atlantic, as economies today remain fragile and unemployment stubbornly high, identifying with the 99 percent has resonated with many earners and savers who are having difficulty navigating the new financial landscape.

Eyes are increasingly turning to the so-called 1 percent. What is the proper role of the ultra-wealthy in addressing these issues? What should we expect from the private equity and hedge fund professionals who earn large sums of money from their investment acumen?

Interestingly, simply being wealthy does not appear to be enough to earn someone the negative sentiment that is directed at the 1 percent by the Occupiers and their sympathizers. It is curious how the bright lights of media coverage that follow around a lottery winner do not invoke the vitriol and judgmental language that a large Wall Street bonus does. This is particularly true if one gives any thought to the shockingly low payout rates of lotteries and how they disproportionately prey on the wallets of the working poor.

Is it right that money won by sheer luck from gambling should be considered morally superior to money that was earned through work? What is it about the manner in which the 1 percent are commonly believed to have acquired their fortune that is giving these critics so much concern?

It is increasingly difficult to find someone who is agnostic about private equity and hedge funds.

Many in the financial industry champion these investment vehicles as a means to deliver absolute returns, regardless of which way the market is moving on any given day, while providing other market participants with much need liquidity.

Critics, however, have become louder and louder in recent years. A number of hedge fund blow-ups have raised concerns over the consequences of speculation on the “real economy.” Names of now-defunct firms such as Long-Term Capital Management and Amaranth Advisors have become bywords for the possible
systemic risks that we could face if a hedge fund is big enough and its bets are wrong enough. With the presidential campaign of Mitt Romney in 2012, private equity was examined under the microscope like never before. Both Republicans and Democrats used stump speeches and debating platforms as a means to attack private equity funds and their managers as job-destroyers who profit from the infliction of widespread financial misery.

Private equity and hedge funds operate within the financial markets alongside the large institutions that populate Wall Street and the City of London. However, their entrepreneurial nature distinguishes them in a number of very important respects from investment banks, stock brokers and other firms of intermediaries. Private equity and hedge funds are not middlemen. They actually buy and sell financial assets rather than simply facilitating transactions by other market participants. They take risks in a way that traditional intermediaries avoid (at least intentionally).

Even though these funds seek to make profits regardless of how the markets are moving on any given day, they are still impacted, directly and indirectly, by the same sentiments that affect economic life on Main Street. The accumulation of millions of individual decisions to buy this product instead of that product, or to hire one service over another service, necessarily shifts the value of financial instruments over time. As private equity and hedge funds back one company or industry over others, they are open to the possibility of stratospheric profit and catastrophic loss. In recent years, it has become clear that the same fund can suffer such profits and losses in quick succession, as one set of decisions goes very well, but another set of decisions goes quite poorly.

Many experts and commentators feel that a healthy, vibrant Wall Street is essential to a robust economy. Few hedge fund managers and private equity firms would disagree.

In April 2012, President Obama signed into law the acronym-friendly Jump-start Our Business Start-ups Act (or “JOBS Act”)
for short). Intended to undo many of the impediments to initial public offerings that were the unforeseen consequences of the Sarbanes-Oxley Act, originally passed in 2002, the JOBS Act seeks to significantly revamp the way in which private capital is raised in the United States. The intended beneficiaries of this liberalization are so-called “emerging growth companies,” whose initial public offerings (IPOs) and resulting jobs and economic growth federal lawmakers want to expedite.

However, private investment vehicles, such as hedge funds, private equity funds, venture capital funds and mezzanine funds, also benefit from the JOBS Act. These funds are now able to more easily obtain money from “accredited investors,” which include those individuals who earn more than $200,000 per year or have more than $1,000,000 in net worth, excluding their family home.

Until now, it has been necessary for anyone approaching prospective investors in the United States to purchase privately-placed securities to have a substantial pre-existing relationship in place in order to actually discuss a particular investment opportunity with them or provide them with marketing materials. Post-JOBS Act, anyone can be approached as long as it is determined before they invest that the individual in question is actually an accredited investor.

What could this mean in practice for private equity and hedge funds seeking more capital from new sources?

Perhaps full-page advertisements in a widely circulated daily newspaper, or GQ magazine, or Sports Illustrated? Maybe commercials during the Super Bowl, or during the sombre Sunday morning talk shows, like “Face the Nation” or “Meet the Press”? What about mass mailings to everyone in the state who bought a Mercedes-Benz or a Rolex watch, last year? All of the above are now fair game!

As private equity and hedge funds continue to enter mainstream life in the United States, the United Kingdom and around the world, it becomes more and more important for all of us to have a clear understanding of what it is that they really do, who benefits
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from their successes and who is at risk from their losses. These funds and the firms that manage them are too important to ignore or to explain away with simplistic and shallow rhetoric.

In the following pages, the story of how private equity and hedge funds operate in the modern economy will be laid out, together with insights into how they are structured, staffed and sold to investors.

These funds have been with us for several decades and can be seen to have evolved naturally to provide services much in demand from institutional and other sophisticated investors. However, it has only been in the last few years that these funds – and their often highly remunerated managers – have broken into wider public attention.

As a result, there are still many misconceptions and biases about them that fill the mainstream media. Only by stripping these inaccuracies away can we fashion a useful and compelling portrait of these financial entrepreneurs. Once we have done this, we can then start to form a view on what is the best approach for integrating these funds into our financial, economic and political lives.

But first, an aesthetic question is now in order. What do poets, those unelected legislators of the world, think about private equity and hedge funds?

Fortunately we do not have to rummage through countless Quatro-size pages of free verse and labored sonnets to find this answer. Instead, we can look to a scandal that recently enveloped a leading British literary prize, and subsequently reached newspapers and media reports around the world.

In 2011, to great media fanfare, two well-known poets, Alice Oswald and John Kinsella, withdrew their names from consideration for the Poetry Book Society’s prestigious T.S. Elliot Prize. The reason? The prize that year was sponsored by Aurum Funds, a hedge fund, which donated money when the Society lost
its public grant due to cuts in the British budget that were a consequence of austerity measures.

As you would expect from a poet, Kinsella was not at a loss for words. When asked why he withdrew his name from consideration, he pithily referred to hedge funds as the “very pointy end of capitalism.”

The JOBS Act is opening the door for more wealthy, experienced investors in the United States to put their money to work with private equity and hedge funds at capitalism’s “very pointy end.” These new investors join the hundreds of thousands of investors around the world who have begun allocating money to these alternative funds in recent years. Some of these investors will be rewarded, others may lose significant sums, but that pointy end of capitalism is a necessary component that allows the rest of the economy to operate effectively and efficiently.

There is no need either to demonize or romanticize private equity and hedge funds. Capitalism’s pointy end is where they must operate in order to uncover those lucrative returns for their investors.

Post-JOBS Act, President Obama and the US Congress are placing responsibility for these investment decisions squarely in the hands of interested investors. As a result, prospective investors in private equity and hedge funds must dedicate the necessary time and attention before they invest in order to ensure that they do not end up sticking this “pointy end” into their own eye.

It is to this “pointy end,” therefore, that we now turn.
PART ONE: WHAT WE TALK ABOUT
WHEN WE TALK ABOUT PRIVATE EQUITY AND
HEDGE FUNDS
1: THE POINTY-END OF CAPITALISM

A Short Introduction to Private Equity and Hedge Funds Without Charts or Graphs

Hedge funds, private equity funds and other kinds of investment vehicles help to dispose risk and add liquidity.
Timothy F. Geithner, President of the Federal Reserve Bank of New York, October 18, 2005

You've seen very, very dramatic enforcement actions already by the enforcement authorities across the US government, and I'm sure you're going to see more to come. You should stay tuned for that.
Timothy F. Geithner, US Secretary of Treasury, October 14, 2011

Perhaps no single building in the world is as much a monument to the rise of private equity and hedge funds as 9 West 57th Street in New York.

Home to private equity giants (KKR & Co. LP and Apollo Global Management LLC), rising stars (Silver Lake Partners) and start-ups (Lightyear Capital and Sycamore Ventures), as well leading hedge fund managers (Och-Ziff Capital Management), this office tower provides an enviable home to many of the most successful practitioners of alternative investing, or at least those willing to pay $200 a square foot for the privilege.

Owned by real estate tycoon Sheldon Solow, and identifiable at some distance at street level by the iconic red “9” located in front of the building, the office tower block has an impressive history. So high-profile is the building and its tenants that when a power
outage occurred and the elevators failed, the New York Times quickly reported about “private equity deal makers” who were “forced to hoof it up as many as 20 flights of stairs – 20 flights!”

On a cool autumn afternoon, midtown Manhattan looks and feels significantly different from the historic home of American financial capitalism that is located further south in the downtown area surrounding Wall Street. Just a short walk from Park Avenue and the traditional homes of New York’s aristocracy, the tenants of 9 West 57th Street clearly don’t need to be in New York. Many of them could just as easily be operating from offices in Greenwich, Connecticut or a designer loft in Tribeca. They could be staring at Bloomberg screens or reviewing portfolio company spreadsheets on a yacht floating just off a picturesque beach in the Seychelles or at their ski chalet in Corchaval.

Unlike the older parts of the financial industry that grew up adjacent to, or in ready walking distance from, a stock exchange or a central bank, private equity and hedge funds have found their footing and taken their rightful place in the current financial hierarchy at a time when technology has freed them from both physical locations and the need for “safety in numbers.” Perhaps that is part of the reason why a growing number of people in positions of influence and power have begun to express concerns about these new financial entrepreneurs. Perhaps their short histories and small, discreet offices, which seem slightly out of place when compared with their ability to influence events in the financial markets, cause a certain amount of unease.

When you are standing in front of a building housing a bulge-bracket investment bank, such as Merrill Lynch or Morgan Stanley or Goldman Sachs, or a financial powerhouse, such as Citibank or JP Morgan or UBS or Deutsche Bank, you know very clearly whose headquarters you are loitering in front of, with a double skinny latte in your hand. Regardless of whether you happen to be in New York or London or Frankfurt or Tokyo or Hong Kong, these firms are very keen to let you know, in no uncertain terms, “Here we are!”
The Pointy-end of Capitalism

The indifference of private equity and hedge fund firms to public acknowledgement and popularity, at least until very recently, is strikingly different. In the face of this aloofness, in part driven by regulatory restrictions and the exclusively non-retail nature of their investors, these funds must now answer mounting questions about who they are and what it is that they actually do.

To begin at the beginning, a fund is an answer to a question. This question will typically involve how to connect people with talent, but insufficient money, with people with money, but insufficient talent, in order to allow the former to make investments on behalf of the latter. Simple enough. Whether the fund in question is a mutual fund for retail investors, a retirement fund for employees of a particular company or government department, a film fund looking to finance a slate of motion pictures, or a real estate fund planning to buy apartment buildings for university students, the same basic commercial logic applies. And it applies to private equity and hedge funds just as well.

In an ideal world, each investor who desired the services of a particular investment adviser would have enough money to entice this adviser to take his or her money and manage it subject to individually negotiated parameters, customized to fit the investor's particular needs. The investment objective and remuneration for such an account would be determined based on the requirements of both parties. This, however, is not an ideal world.

Many investors, unfortunately, lack the sums of money required to meet typical account size minimums set by established and proven investment advisers, which can start at $25 million. Funds, therefore, are created as a means to aggregate these individual sums of money into a single pool, which can be managed efficiently and effectively. Each investor in the fund is entitled to a portion of the proceeds from the fund in proportion to the amount of money they initially contributed, less any expenses and fees provided to the fund manager.
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Through a fund, the professional services of an investment adviser can be provided to a large number of prospective clients, so long as all agree that they are pursuing similar investment objectives. In order to provide these services, an intermediary vehicle is placed between an investment manager, on the one hand, and a group of potentially disparate participants, on the other. The vehicle serves both as a means of pooling the investors’ money and as a single client for the investment adviser.

The use of funds provides access for the individuals and institutions with smaller sums to invest to investment advisers who would not otherwise be commercially motivated to take them on as clients. Additionally, these vehicles provide investment advisers with administrative efficiencies where multiple clients wish to retain the firm to provide substantially similar services.

It is probably worthwhile making a few observations about the modern hedge fund and private equity fund industries before going into too much more detail about how these funds are structured and operated. Because of their private nature, there are no generally accessible central repositories for information on these funds. This has historically made rigorous analysis about the size, number and activities of private equity and hedge funds more difficult to conduct, at least when compared to the wealth of publicly reported information available on banks, insurance companies, brokerage houses and other financial firms. As a result, for those eager to uncover a little more information about these funds and their managers, the best sources of data are often either trade associations or private commercial firms who have been able to accumulate enough information upon which to make reasonable estimates.

In the case of private equity funds, it is estimated that close to $3 trillion dollars are invested in these funds, with just under 70 percent of new funds launched by managers based in the United States (50 percent) and the United Kingdom (11 percent). In the case of hedge funds, it is estimated that there are approximately 6,800 hedge funds in existence, managing over $2 trillion in assets. The majority of hedge fund managers are based in the United
States, with the United Kingdom being the next largest country. Estimates for 2013 show continued growth for both asset classes.

Clearly these are significant industries, which have grown up quickly in the last few decades. Perhaps most surprising is the relatively small amount of independent research and academic work that has been attempted on these funds, at least until very recently. One might be forgiven for expecting that these industries would have been the focus of extensive research and analysis by leading experts and research universities around the world. In reality, academics have shown surprisingly little interest in uncovering the truth behind the rumors and accusations and public relations banter that surround private equity and hedge funds. As a result, the debate has largely been left to partisans.

Are private equity and hedge funds “mysterious” and “controversial”? Are they “inherently evil?”

Periodically, stories bubble up in the mainstream press that paint these funds in a poor light. Unfortunately, both critics and champions of alternative funds attempt to reduce complex financial transactions into simple language. In doing so, important details are inevitably lost and the search for meaningful insights is thwarted.

A quick perusal of recent newspaper headlines makes it clear that hedge funds are squarely on the radar of a wider cross-section of society than ever before. They present hedge funds as an opportunity (“Good at Chess? A Hedge Fund May Want to Hire You” or “Pitching the Hedge Fund Masters”) or a threat (“Big British Hedge Fund Takes Aim at the States”), as a potential force for good (“Hedge Fund Chief Takes Major Role in Philanthropy”) or a potential force for evil (“Hedge Fund Manager Gets 60 Years for Fraud”), or simply as a odd source of humor and diversion (“Hedge Fund Hippies”).

But what does an actual, real life hedge fund really do? Hedge funds have been described as “mutual funds on steroids.” This is not an entirely unhelpful first impression. If mutual funds
take risks on what stocks will go up and currency exchange rates will go down, hedge funds take very, very big risks. Unsurprisingly, the individuals taking these risks are celebrated and admired when their bets pay off. The roll call of great hedge fund managers includes many names that are becoming more familiar to casual readers of mainstream newspapers and magazines: Arthur Samberg, Paul Tudor Jones, Philip Falcone, Steve Cohen, Paul Singer.

Are hedge fund managers really the smartest people around? This is an alluring, but obviously quite futile, question. Regardless of whether they are or aren’t, they are still human. They are capable of making mistakes, and many do. Interestingly, like professional athletes, often the heights reached early in a career will not be seen again as the years go by.

Each year, many new hedge funds are launched in the hopes of attaining the success and recognition of the giants in the industry. In 2012, for example, new start-up hedge funds came to market focusing on a diverse range of investment strategies, including FMG Mongolia Fund (emerging markets), Context BH Partners LP (equity long/short), Citizen Entertainment Fund Ltd (fixed income), Ancora Merger Arbitrage Fund LP (merger arbitrage) and 36 South Black Eyrar Fund (volatility trading). There are now even firms which are dedicated solely to identifying new managers and backing them in their early days with significant early investments. Known as “seeders,” firms such as IMQubator and Reservoir Capital have had great success at picking the next generation of star hedge fund managers. Notably, IMQubator is ultimately backed by APG, the Dutch pension fund, a significant institutional investor.

In addition to single strategy hedge funds that may invest in Japanese equities or high-yield bonds of technology companies, there are also funds whose sole purpose is to invest in other funds. Known as funds-of-funds, firms such as Grosvenor Capital Management, Lyxor Asset Management, K2 Advisors, Pacific Alternative Asset Management Company and Financial Risk Management have received billions of dollars from investors in order to assemble diversified portfolios of underlying hedge funds.
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Their clients simply need to write a single check to gain access to a collection of funds selected and overseen by their teams of experts. Taking the first step toward including hedge funds in your multibillion investment portfolio couldn’t be easier for the institutional investor with the courage and wherewithal to embrace alternative investments. Or so it would seem at first.

The actual term “hedge fund” is notoriously difficult to define with any precision.

In part, this is due to the derogatory manner in which the phrase is now often used. At its broadest, “hedge fund” can refer to all unregulated investment vehicles not otherwise categorizable as “private equity funds” or “real estate funds.” An overly narrow definition might settle on those funds that engage in highly leveraged trading strategies which utilize short selling or complex derivatives. Neither approach is particularly helpful for the informed layperson eager to learn more about their motivations and activities.

It would be more useful, perhaps, to simply describe certain of their key features and establish a working definition from there. Hedge funds constitute private pools of capital, with investors meeting certain net worth or sophistication requirements. Unregulated by the US Securities and Exchange Commission (SEC), the UK Financial Conduct Authority (FCA) or other relevant regulators, hedge funds are not subject to the limitations and restrictions imposed on their public fund brethren, such as retail mutual funds in the United States or authorized unit trusts in the United Kingdom.

These funds generally invest in publically listed securities and derivative instruments based on such securities. The strategies followed by hedge funds can be categorized in a number of ways. One possible set of groupings would include: “long/short,” which combines long positions with short sales; “event driven,” which seeks to identify the likelihood of certain corporate transactions; “relative value,” which seeks to exploit pricing discrepancies that arise between securities; and “tactical trading,” which identifies
and follows macro-economic and other trends in various markets. Importantly, new strategies are being conceived of every day, as bright young men and women discover unique trading opportunities that arise from the day’s headlines.

A few generalizations can also be made about the economics of a hedge fund. It is common for these funds to charge a performance fee, based on the success they have pursuing their investment strategy, in addition to an asset-based management fee, based on the amount of money provided by investors. Also, the capacity constraints imposed by certain investment strategies mean a limit may exist on how much capital can be employed by a particular hedge fund without negatively impacting its returns and, thereby, the lucrative performance fee accruing to the fund manager.

Structurally, hedge funds may be set up either onshore (i.e. in the market in which the investors are located) or offshore (i.e. in a different market). They make use of either tax transparent entities, such as limited partnerships, or tax exempt entities, such as companies established in jurisdictions where broad tax derogations are possible. The most common offshore jurisdictions are no doubt the Cayman Islands, located in the warm waters of the Caribbean. Hedge funds are typically open-ended. This means that they issue and redeem units or shares directly with investors on a regular basis, based on the net asset value of the units or shares on a particular day. The mutual funds and unit trusts sold to Uncle Edgar and Aunt Edna are also open-ended, allowing retail investors to move money in and out when needed. By contrast, the units or shares of closed-ended funds (such as a private equity fund) are not eligible for interim liquidity. As a result, they must either be held until liquidation or traded from investor to investor in secondary transactions.

Currently (and for the foreseeable future) the primary investor market for hedge funds is the United States, consisting of US tax-exempt investors, such as public and private pension funds and university endowments, and US high net worth investors. However, the significant growth in United Kingdom and European based fund managers over the past fifteen years has meant that
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structuring hedge funds has become an increasingly multi-national endeavor.

Alfred Winslow Jones is widely acknowledged as having established the first hedge fund in 1949. Unlike the Abner Doubleday myth that shrouds the origin of baseball, the American national pastime, there are actually reliable contemporaneous reports of Jones’ investment venture and how he sought to differentiate himself from the other money managers plying their trade in the United States in those early, post-War years. Over the intervening decades, the universe of hedge funds has expanded far beyond the relatively straightforward long/short equity strategy Jones pursued. Now the term “hedge fund” is casually used to encompass any strategy that seeks to generate positive returns irrespective of rises and falls in the securities markets.

A frustrating feature of hedge funds for many would-be investors is the lack of transparency with regard to a fund’s actual holdings. Investors rarely receive position-level information about a fund’s portfolio. Fund managers are often very concerned that this information could be used by third parties to trade against their fund and harm its performance over time. Often, the profits captured by hedge funds can be based on small price differentials that could evaporate before they have fully completed their trading.

A growing trend in the market, however, is for hedge fund managers to provide significant institutional investors and funds-of-funds with limited, but meaningful, information about the fund’s holdings. This information can be provided in an aggregated manner, by sector or geography or currency, rather than a complete listing of each stock or bond or derivative held. In this way, concerns about “trading against” the fund can be addressed, while still providing useful metrics to concerned investors about their risk exposure. This tiering of transparency is steadily becoming a feature of market practice, as individual investors remain willing to accept significantly lower disclosure as the price for access to hedge
funds. Institutional investors, on the other hand, have fiduciary duties that they owe to their ultimate beneficiaries. These duties require them to seek and obtain increased transparency in order to allow them to fulfill their own legal obligations. An institutional investor who fails to take adequate steps to oversee the managers with whom they entrust their money could find themselves facing costly (and embarrassing) litigation from their beneficiaries, whose interests they were charged with protecting.

Perhaps unfairly, hedge funds are often associated in the mainstream press and in popular imagination with fraud and other criminal activities. Little is reported about most funds most of the time, but when a significant loss occurs, or rumors of fraud begin to circulate, the financial pages regularly fill up with scandalous stories. As a result, it’s easy to envision the managers of many of these funds as pantomime villains, who are simply waiting for their chance to rob their helpless investors blind when the right opportunities arise.

In fact, the actual cases of such frauds have been relatively few, both in absolute and relative numbers. Even where no criminal malfeasance occurs, however, investors in hedge funds can suffer catastrophic losses where comprehensive risk management systems are lacking and unforeseen market developments expose weaknesses in the construction of the portfolio and its risk exposure. The global financial crisis provided us with many examples of these.

As a result, the most successful investors will always be actively considering and re-considering which funds to invest in and how much money to entrust with each one. Investor preferences and prejudices have a surprisingly large impact on which managers survive and thrive and which managers eventually withdraw from the market. The preferences and prejudices of investors have been a significant driver in determining the shape and scope of today’s hedge fund industry. In order to fully understand the nature and operation of these funds, a full understanding of the motivation of these investors must be developed. Absent that, the concerned layperson is only evaluating half the picture.
Since the global financial crisis, it has been particularly hard to be a small hedge fund.

Many of those brave investors who eventually re-entered the market after the dramatic events of 2008–2009, when over 1,000 hedge funds closed and many more reneged on their promise to give investors their money back, still shy away from all but the largest hedge funds. Those intrepid souls who are now willing to write checks seem inclined to write checks so large that many funds just starting out are unable to accept them without throwing their portfolios, and their investor demographics, well out of whack. In addition, many cautious investors take comfort (whether deserved or not) in the belief that larger managers must have withstood the test of time in order to reach their current size, and therefore are somehow less risky. Experience, however, often teaches otherwise.

But regulatory developments, and the insatiable human desire for success and monetary rewards, have meant that more new hedge funds continue to launch each year. For example, as the Volcker Rule, a highly controversial provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), forces banks in the United States to disgorge their proprietary trading desks, and the hot-shot quants and superstar traders who staff them, there are growing numbers of start-up hedge funds opening their doors and looking for anchor tenant investors. Interestingly, studies have regularly indicated that many fund managers (like athletes) do best in their early years. As a result, a perverse effect of the preference for larger established fund managers with audited five-year track records is that investors who categorically exclude new managers from their allocations could potentially be significantly limiting their returns.

If there is indeed some measure of added risk in backing a start-up fund, how can an interested investor make sure that they are being adequately compensated for taking that additional risk?

For an investor willing to make a substantial investment in a new fund at its initial launch, it is not uncommon for that investor to receive an ownership interest, and a profit participation, in the
fund manager. To the extent that the fund is a roaring success, this anchor tenant investment could significantly increase the investor’s overall return by adding a share of the manager’s lucrative performance fee to the investment performance of its own money at work in the fund. This seed investment recognizes the value added to the manager’s nascent business by the validation provided by an established, respected institution entrusting money with the new team on day one. Such value is real and measurable and on the table for the right prospective investor.

Understanding what hedge funds actually do requires a more-than-casual familiarity with the large investment banking teams that are these funds’ entry point into the global markets – that is, prime brokers. Trading securities on the scale and with the frequency of the most successful hedge funds takes more than a few Bloomberg screens and an online brokerage account. Prime brokers are central to the operation and ultimate success of most hedge funds, especially those that want to sell short or to magnify their bets with borrowed money.

In many ways, there would not be hedge funds if it weren’t for the large, bulge-bracket investment banks like Goldman Sachs, JP Morgan, Bank of America Merrill Lynch and Credit Suisse that provide them with these prime brokerage services.

What does a prime broker actually do? In addition to execution and custody services, a prime broker provides hedge funds with the ability to borrow stocks and bonds (known as “securities lending”) and to borrow money to buy stocks and bonds (known as “margin financing”). The prime broker stands as an intermediary between hedge funds and two important sets of counterparties – on the one hand, pension funds and other institutional investors with shares to lend (for the ultimate purpose of short selling); and on the other, commercial banks with money available for margin loans.

Short selling is so closely associated with hedge funds that perhaps a few words of explanation are warranted. When selling
a security “short,” the underlying bet being made is relatively straightforward. By engaging in short selling, an investor is betting that the price of a security will fall. In a properly functioning market, prices rise and fall regularly and freely. As a result, shorting can be seen as a way of ensuring that price bubbles burst before they distort the market and end up causing catastrophic losses to innocent (and not-so-innocent) bystanders. Although the effect of short sellers on a particular company can be very painful to the management and shareholders of the target under siege, many experts believe that the contribution to overall market efficiency outweighs the short-term pain that short selling inflicts.

In addition to lending either securities or cash, prime brokers also offer a number of concierge services to their top hedge fund clients. “Capital introduction,” for example, is provided by dedicated teams within a prime broker to assist new funds in identifying new potential investors. In practice, however, the results of these matchmaking services can be highly varied. At the very least, these services can expedite the fundraising process for strategies and individual principals currently favored by the market. Although in recent years prime brokers have expanded their services to include risk management and capital introduction, securities and cash financing remains their core (and most profitable) services.

The differences between borrowing cash and borrowing securities are significant to a hedge fund, and worth expanding on in more detail. While lending cash is a commodity service with a transparent cost structure, lending securities is not. As a result, spreads (and ultimately the profit to the bank) can vary widely.

Lending often requires collateral, and prime brokerage is no exception. Prime brokers typically operate on a fully collateralized basis. As a result, the assets of a hedge fund are held by the prime broker in its role as custodian. Those assets are, therefore, available when needed at a moment’s notice as collateral, at which time they are quickly transferred to the prime broker’s own account. This allows a prime broker, with custody of a hedge fund’s portfolio,
to provide higher leveraging amounts to these borrowers than they would otherwise receive from traditional bank loans.

A very important distinction needs to be made at this juncture. Collateralization is different from leverage, a topic that will come up again and again in the following chapters. Leverage refers to the use of borrowed money. Using borrowed money to buy stocks and bonds has traditionally been referred to as “margin finance.” Like with the purchase of residential real estate, a buyer will have some, but not all, of the purchase price and will look to a lender to supply the balance.

The margin terms made available by the prime broker to the hedge fund will determine the maximum leverage (or borrowings) available. Often, funds may find themselves in the position of being offered more margin at a given point in time than they want. Hedge fund managers must familiarize themselves fully with a prime broker’s margin rules as well as how those rules are developed and implemented over time, in order to ensure that unexpected movements in the market do not have unforeseen effects on a fund’s portfolio.

Selecting the right prime broker is always a very important decision for a hedge fund manager, regardless of whether they are a new start-up or a multi-billion dollar fund closed to further investments. The factors typically considered by hedge funds in choosing a prime broker include price, access to hard-to-borrow securities, credit worthiness and access to term lending. In practice, many prospective investors do take comfort (whether rightly or wrongly) in the selection of a particular prime broker by a new hedge fund manager. This is due to the level of due diligence perceived to be involved in a leading financial institution agreeing to have a particular fund as a counterparty.

Typically, a detailed understanding of the individuals behind the fund manager, the structure of the management operations and the investment process to be followed by the fund is developed by the prime broker before a hedge fund is taken on as a client. However, because of its position as an over-collateralized creditor,
the prime broker’s view of risk differs quite significantly from an investor’s view of risk.

Just like hedge funds, private equity funds have steadily gained in prominence over recent years. Flipping through leading newspapers also reveals that these funds are subject to a range of different and often contradictory perceptions. Private equity funds are either conquering the world (“Private Equity Goes International” or “Private Equity’s Love Affair with China”) or on the verge of seeing their best days behind them (“Defending Private Equity from a Flawed Picture”). They may be wrestling with divisive internal conflicts (“A Clash Between Venture Capital and Private Equity”) or benefiting from a broad consensus among leading practitioners (“Private Equity Titans Find Common Ground”).

Private equity funds differ in many important respects from hedge funds, even though they share several common traits in terms of their structure and operation. Private equity funds are unregulated investment vehicles formed to facilitate investments in listed and unlisted shares and other securities. Such investments may also include public companies that, after acquisition by the fund, will be “taken private” and delisted. Traditionally, these funds have focused on capital appreciation rather than current income. Accordingly, they are usually established as closed-end funds where an investor’s money may be locked up for between ten to fourteen years.

A number of different strategies to access investment opportunities in public and private companies can be grouped under the heading of “private equity.” These strategies may be categorized under three broad headings. First, venture capital funds invest in young, entrepreneurial companies, frequently focusing on new technologies. Second, buyout funds purchase significant positions in mature businesses, often with significant amounts of borrowed money, with a specified exit period. Third, special situations funds are active in a broad array of debt instruments and other investments in distressed or rapidly changing companies.
Once a decision is reached by an investor to allocate money to private equity, there are a number of different options available. The investor could identify and invest directly in particular target companies, assuming he has access to potential transactions and the time and expertise to negotiate and oversee. Alternatively, the investor could invest in a private equity fund, which would allow him access to investment professionals with demonstrated abilities and past success, together with the benefits of increased diversification across a number of investments. Finally, the investor could allocate to a fund-of-funds, which would make available to him a portfolio of different private equity funds across strategies and vintage years, many of which he would not have been able to invest in directly.

Two key features of private equity funds easily distinguish them from hedge funds. First, an initial “commitment” is made at the launch of the fund to provide up to a certain amount of capital to the fund whenever required, rather than fully investing a sum of money on the first day. Second, the fund has a fixed life, ranging from seven to ten years, with all investments having been made during the defined life being realized on or before the termination date.

These features derive from the types of investments targeted by private equity funds – typically, illiquid stakes in unlisted companies. For example, private equity funds require a commitment from investors of up to ten years, which may be subject to further extensions. Upon launch, only a fraction of the investor’s capital commitment will be payable, with the balance drawdown as and when investments are identified. The investment period may range from three to five years with a distinctive drop in performance in the fund’s early years (known as the “J curve” or the “hockey stick”) due to the small amount of invested capital and the effect of organizational expenses and management fees until investments begin to be realized.

Although private equity funds have, until very recently, provided fairly consistent rates of return, they have certain pronounced disadvantages to many investors. These include irregular capital calls,
difficulties in forecasting the distribution of cash proceedings and highly illiquid investments by the fund that can be difficult to value. Private equity funds clearly do not suit every investment portfolio. As a result, typically only the largest institutional investors around the world have allocated their money to these funds.

In most other ways, however, the similarities of private equity and hedge funds far outnumber the differences. They are typically established as unregulated collective investment schemes and have surprisingly similar asset-based and performance-based remuneration. These structural similarities will be discussed and dissected in the following chapter.

Before commencing any rigorous analysis of the private equity industry, it is important to maintain a proper sense of scale when talking about the size of these firms and the funds they manage. A private equity firm managing, say, $4 billion can be referred to as “mid-sized,” even though they may have high-profile institutional investors, such as the California Public Employees’ Retirement System (CalPERS) and Harvard University, participating in their fund. The “big guys” in the industry are firms like Henry Kravis’s KKR & Co, Steve Schwarzman’s Blackstone Group, David Rubenstein’s Carlyle Group, Leon Black’s Apollo Global Management or David Bonderman’s TPG Group, who have several times more in investor capital to put to work in each fund they raise.

For example, in 2011, when sentiment was still only turning back in favor of private equity, the largest fund to successful launch was Lexington Capital Partners VII, which closed on $7 billion. Importantly, the Lexington fund is a “secondaries” fund, which focuses on buying the limited partnership interests of other (“primary”) funds from disaffected investors seeking liquidity. Other significant funds that launched in 2011 included the Swedish-based EQT VI (Euro 4.75 billion), Oaktree Capital Management’s OCM European Principal Opportunities Fund III (Euro 3 billion),

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ONE STEP AHEAD

Summit Partners Growth Equity Fund VIII ($2.7 billion) and Australia’s Archer Capital Fund V (AUS $1.5 billion).

Today, some of the larger firms that sponsor and manage private equity funds are now publicly traded on the New York Stock Exchange or Nasdaq Stock Market, such as Blackstone, KKR, Carlyle and Apollo. Although their funds remain limited to only large sophisticated investors, these listings allow any retail investor to log-on to their online brokerage account and buy into these private equity giants, should the whim ever arise. Due to the public disclosure requirements that listed companies must fulfill, more technical information is available about these firms today than many of their competitors. As a result, private equity is steadily becoming less and less “private” with the passage of time. In addition, the passage of Dodd-Frank in the United States led to many private equity firms being registered with, and supervised by, the SEC, although the information required for disclosure is still significantly less than for public companies.

With all these billions of dollars of investors’ money sloshing around, what sort of companies do private equity funds buy? They run the gamut of industry sectors and can vary from small companies looking to expand, to large companies in need of restructuring. These funds can either be generalist in their investment approach or have very specific geographic or industry sectors that they target. It is difficult today to identify a geographic area or an industry segment that has managed to avoid the attention and affection of private equity funds sniffing out big returns.

By way of example, TPG (formerly known as Texas Pacific Group) has held stakes in Caesars Entertainment, J Crew, the Neiman Marcus upscale department stores, IMS Health and Spanish-language network Univision. Carlyle Group, which in 2012 had $150 billion in assets and almost 100 different funds operating across private equity, venture capital and real estate, has invested in communications companies CommScope and Syniverse, as well as Florida-based Bank United. Blackstone portfolio companies have included Bank United of Florida, SunGuard (a software
company) and Leica Camera. Apollo has owned SiriusXM Radio and Lyondell Bassell (a plastics and chemical company).

These acquisitions, and the thousands like them, have meant that growing numbers of men and women in the United States, the United Kingdom, across Europe and around the world now work for companies owned by private equity funds. These companies are being operated and managed (and often restructured and refinanced) in such a manner as to deliver outsized returns to the investors in the fund.

What does this mean to the man or woman on the street who might be worried about the impact of private equity on his or her life and livelihood?

In a bold move to better explain the private equity business model to the general public, the industry reached out to the “Schoolhouse Rock” generation of middle-age men and women who grew up in the United States watching those toe-tapping, easily-hummable Saturday morning cartoons by producing their own animated defense of their business practices. In May 2012, the Private Equity Growth Capital Council released its own cartoon video on YouTube that walked viewers briskly through the inner workings of leveraged buyouts. Although not as memorable as “Conjunction Junction,” and lacking the emotional arc of “Verb, That’s What’s Happening,” the trade association’s first attempt at animation conveyed several important talking points about the way private equity functioned to work with companies in need of capital and expertise in a succinct and understandable manner.

Questions remained in many laypersons’ minds about how private equity fits into the larger economy, but the trade association earned kudos for at least attempting to tell the story of private equity from the perspective of its most sincere practitioners.

As noted above, private equity is becoming less and less “private.” Public scrutiny and negative publicity is now a feature of daily life for much of the industry. In 2012, Colin Blaydon of the Tuck
School of Business at Dartmouth College pointedly observed that “[t]he industry has done a terrible job of explaining what it does, and now has this bright spotlight being shown on it that no one ever anticipated.”

This transition has been difficult for the industry, which historically was not inclined to sing its own praises or engage proactively with the press or with the government. Until the formation of the Private Equity Growth Capital Association in 2007, the US private equity industry had not engaged in coordinated lobbying efforts in Washington DC. By contrast, the British Venture Capital Association (BVCA), which represents both venture capital firms and buyout firms, was first founded over twenty-five years ago and the European Venture Capital Association (EVCA) has been operating since 1983. Interestingly, the membership in the National Venture Capital Association in the United States has traditionally been limited solely to venture firms.

Much of what gets reported about private equity can be very negative. The actual facts, however, on closer examination tend to be much more ambivalent and banal. Academic studies have shown that private equity neither destroys nor creates significant numbers of jobs over time. In addition, private equity-backed businesses do not appear to go under at any higher rate than similarly situated business. Not many catchy sound-bites there for either side, unfortunately.

Much of the academic research that has been done in recent years demonstrates that private equity does create real value in the portfolio companies in which it invests, as well as giving investors the possibility of high returns. Studies from academics at Harvard Business School, Columbia Business School, University of Chicago, University of Virginia in the United States, the University of Oxford in the United Kingdom, as well as professional firms like Ernst and Young and Cambridge Associates repeatedly provide back-up for the basic claims made by private equity’s champions.

According to R. Glenn Hubbard, dean of Columbia Business School, “Private equity firms have an impact on productivity. That
doesn’t mean that people don’t lose their jobs. But the question of whether private equity adds value? It’s settled among economists."

On occasion, a positive story about private equity firms can break through in the mainstream media. In an April 2012 issue of *Bloomberg BusinessWeek*, the mid-sized private equity firm Monomoy Capital Partners was featured in a cover story that sang the praises of their focus on eliminating waste and inefficiencies in their portfolio companies in order to significantly increase their earnings. Contrary to the widespread image of private equity as making money by slashing employee ranks and performing financial acrobatics with balance sheets, Monomoy are portrayed as constructively engaged in increasing the efficiency and effectiveness of the companies that they invest in.

Often, however, partisan political sentiment comes into play, and attacks on private equity can be a proxy for larger philosophical arguments about economic policy. For example, in June 2012, Moody’s Investors Services issued an interesting report that compared private equity owners to other owners when times start going bad for their companies. Counter to public opinion, more jobs are saved under the watch of private equity firms. Regardless, a campaign ad for President Barack Obama’s re-election labeled Republican challenger Mitt Romney as “outsourcer in chief.” This was in addition to the old stump-speech favorite that Romney was a remorseless job-destroyer. The ad focused pointedly on Bain Capital companies that relocated jobs to China and India. This aggressive “politicization” of private equity that became a feature of the 2012 US presidential election is a very important trend that will be discussed in detail in a later chapter.

Importantly, despite efforts to categorize different types of funds into discrete groups, there is a significant amount of overlap. Private equity and venture capital, for example, are similar in many ways. Both represent financial investors growing and professionalizing private companies for either a sale on to a strategic investor
or an IPO that will put the company into public ownership. “Venture capital” is usually used to refer to investments in young, high-growth companies at an early stage of their development. Intellectual property may be crucial to the companies’ success. “Private equity” typically refers to more mature companies, which may either be listed or unlisted at the time of investment. If listed, the company will first be delisted and taken private in order to allow either its capital structure or its operations (or both) to be comprehensively restructured.

Private equity often focuses on situations where public investors lack the ability or resources to address the challenges facing a company. These can include building new businesses from inception, restructuring companies to better face the future or consolidating participants in mature industry to drive profitability. From the perspective of an investee company, private equity can be a very expensive source of capital. As a result, the companies that take money from private equity funds generally are ones that are facing significant challenges in the current market. Better (and cheaper) options simply aren’t available to a manufacturer who is facing relentless competition from overseas firms, or a chain of department stores that haven’t been able to keep pace with internet shopping.

For example, one high-profile acquisition in 2013 involved the purchase of the Twinkies business from the bankrupt Hostess by Apollo Global Management and Metropoulos & Company, two successful private equity firms. The failure of Hostess, due to intractable labor concerns, caused a fear that the much loved snack cakes produced for many years might vanish from store shelves. Where the management of Hostess failed, the investment professionals within Apollo and Metropoulos feel confident that they can succeed.

In both private equity and venture capital funds, any investment bought must ultimately be sold. The point of these funds is not to own a company for decades and decades, come what may. At the most opportune moment, and not more than several years after being acquired, each company must be sold to a willing buyer.
at a significant profit in order to return to investors their original capital, together with sufficient profit to provide for the carried interest to become payable. The ultimate exit strategy is, therefore, a crucial element of any investment decision.

Although as a general rule private equity and hedge funds each pursue different investment objectives, there is potential for overlaps. At certain times, these different funds can find themselves actually competing against each other for the same prospective investments.

In 2011, for example, a new technology bubble was starting to build. Unsurprisingly, some hedge funds eventually decided against simply waiting for allocations in the next hot IPO. Instead, they began to put money in start-up companies while they were still private. As a result, they found themselves in direct conflict with established venture capital houses whose sweet spot is providing expansion capital to young businesses in the hope of either taking them public or selling them to an established industry leader. Unlike venture capitalists, hedge fund managers are not typically known for their patient, long-term perspective, or their hand-holding bedside manner, should a start-up company run into some challenges along the way!

Another example of competition can be seen with so-called “vulture funds.” These are funds that invest in distressed, or undervalued, assets. They can follow any of a number of particular investment strategies, which often differ significantly as to the liquidity of their investments and the turnover of their portfolio. As a result, these funds can be established as either open-ended hedge funds or closed-ended private equity funds. In fact, they may even be structured as highly customized vehicles exhibiting some characteristics of each approach.

Of the two possible approaches for structuring a distressed fund, two key factors of the hedge fund structure are worth noting. First, performance fees in a hedge fund are earned on both realized and unrealized gains, so the need to harvest investment inherent in a private equity fund structure is absent. Second, as an open-ended
fund, new investors can come into the hedge fund on a regular basis and existing investors can similarly redeem themselves out, so the hedge fund can continue indefinitely. On the other hand, a private equity fund structure may be more appropriate where the fund acquires large positions within a single company, exerting some level of influence on the company or its restructuring process, or where the valuation of the investments it acquires will be problematic. This is a good example of where decisions as to a fund’s structure (discussed in more detail in the following chapter) can determine the types of investors or investments that a fund will pursue.

Due to the manner in which alternative investment funds have evolved over the last few decades, private equity funds are typically described using different nomenclature from hedge funds. Similarly, onshore funds are often described using different terms and concepts from offshore funds. However, the similarities between these funds far outweigh the differences. In addition, structural approaches once common in one category of funds are now finding uses among other categories. Finally, investors and regulators, such as the SEC and the FCA, are increasingly viewing alternative investment funds as a single broad category of investment vehicles.

Understanding the points of commonality between these funds, therefore, has become imperative. As a result, the approach taken here will be to use terminology that is “asset class neutral” to the fullest extent possible. Clearly certain circumstances will arise where it is essential to discuss particular aspects of a fund, its structure or its operation in a specific context. In many circumstances, however, the following terms and concepts will be used regardless of the fund’s structure or investment strategy.

The term “alternative investment fund” will occasionally be used to refer to both private equity and hedge funds, as well as other similar private funds offered exclusively to non-retail investors.
These other funds could include venture capital funds, distressed debt funds, mezzanine funds, as well as a variety of others.

The “fund” is the legal vehicle in which one or more investors place their money in exchange for an ownership interest in that vehicle. The money provided will be aggregated and managed to the greatest extent possible as a single pool, irrespective of the identity (or subsequent views, doubts or reconsiderations) of the investors. Although funds may be structured on other bases, almost all funds are established as blind pools. As a result, once an investor has invested or committed his money, the fund manager will have an almost completely unfettered discretion over what to buy and what to sell, as well as, in many instances, when and on what terms an investor can be given back his money.

The “fund manager” is the party responsible for the operation of the fund and the selection of investments. Where investments will be held for a considerable time, the fund manager may become highly involved in the oversight of particular investments. Where investments are not liquid, the manner and timing of realization will be of critical importance to the fund manager’s success.

The “investors” are the persons participating in the fund. The form of their interest in the fund will be dictated largely by the fund’s choice of legal entity. An investor’s interest may take the form of a partnership interest, in the case of a limited partnership, or shares, in the case of a company.

Hopefully, this simplified terminology will serve to clarify many of the similarities that exist among the thousands and thousands of private equity and hedge funds now operating around the world, as well as the hundreds of new funds being formed each year. It is important for a layperson keen to understand the actual structure and operation of these funds to be able to identify and track their key elements, without being distracted or discouraged by jargon.

Despite their reputation as being unregulated, many legal and regulatory issues in fact arise in the structuring and operations of
alternative investment funds, including the interaction between the
fund vehicle and the investment firm acting as the fund manager.

Generally, the individuals and investment firms who launch
alternative investment funds will attempt to minimize the extent
of their regulation. In the United States, exemptions will be
secured under the Securities Act of 1933 (the Securities Act),
the Securities Exchange Act of 1934 (the Exchange Act) and the
Investment Company Act of 1940 (the Investment Company Act).
These exemptions are provided by the government to address
circumstances where regulation has been deemed unnecessary.
This can be, for example, because of the sophistication of the
individuals involved or because of the limited scope of activities
conducted. In the case of alternative investment funds and their
managers, the regulatory regimes in both the United States and
the United Kingdom focus on regulation and oversight of the
fund manager as an authorized firm, and not on the structure and
operation of the fund itself. This distinction has been questioned
recently, particularly in the months immediately following
September 2008. Today, the wisdom of this approach is still an
open question in some quarters.

As a result of “opting out” of the regulation imposed on public
funds marketed to retail investors, like Uncle Edgar and Aunt
Edna, the extent to which private equity and hedge funds provide
for investor protection concerns varies greatly from structure to
structure. Proactive steps, therefore, must be taken to ensure that
investors fully understand the current status and prospects of their
fund, and that they are empowered to intervene effectively should
the need arise.

Balancing risk and reward in a commercial relationship is
always challenging. In the context of investing, the risks can be
particularly complex and interconnected. Alternative investment
funds seek to generate high returns against a background of
external factors over which they have little direct influence,
including market volatility, counterparty risks, liquidity crises
and political uncertainty.
The Pointy-end of Capitalism

Where funds are not registered for public distribution to retail investors (as is the case of private equity and hedge funds), the non-retail investors who elect to participate in them are left to negotiate any limitations and protections with the fund and the talented men and women who seek to manage their money. Much of the legal and regulatory regime that surrounds these funds is based on the assumption that these negotiations are effective. Unfortunately, during the global financial crisis awkward questions arose about the real effectiveness of these negotiations.

When prospective investors are contemplating an investment in a particular fund, their analysis will primarily (if not exclusively) focus on the skill and abilities of the fund manager. The assembled wisdom and experience of other fund service providers and participants will be an overwhelmingly secondary concern, if it is even expressly considered at all. Similarly, each investor will expect only limited circumstances where management of the fund can be materially changed by action of the other investors. Instead of control, the governance issues that arise in private equity and hedge funds are focused around the need for the fund manager to be held accountable to fund participants as they exercise their broad discriminatory authority.

The legal vehicles which predominantly serve as private equity and hedge funds have established their prime position not due to any inherent advantage or benefits to be found in their internal governance structures. In general, both limited partnerships and offshore companies offer tremendous flexibility for fund managers to significantly limit the influence and oversight of participants, while facilitating the ability of managers to exercise control. The typical choice between either doing nothing or attempting to suspend the manager or terminate the fund is often too stark to address any situation other than the most dire and catastrophic. Simple problems can often be better solved by simple solutions than with extreme solutions. Where investors have recourse only to extreme solutions, fund managers may feel immune to investor sentiment when making important decisions for the fund.
ONE STEP AHEAD

Importantly, even where the funds they manage are unregulated, investment managers that are regulated by the SEC or the FCA owe regulatory duties arising under the Investment Advisers Act of 1940 (Investment Advisers Act) in the United States and the Financial Services and Markets Act (the FSMA) and EU legislation in the United Kingdom.

In the case of public investment funds, such as retail mutual funds, comprehensive product-level regulations have been adopted to ensure that risks associated with conflicts of interest, lack of transparency and mismanagement, as well as portfolio risk, are adequately addressed. In the case of private equity and hedge funds, the participants are expected to rely on their own ability to negotiate adequate levels of protection to address those risks. If they fail to negotiate effectively, they will be left exposed and with limited (or no) recourse.

As a consequence of limiting the extent to which alternative investment funds may be marketed and establishing particular status or size requirement in participants (e.g., sophisticated investors), the presumption of the SEC or the FCA will be that such investors have adequate negotiating leverage to address any concerns over the operation and governance of these funds that they may have. The reach of regulators in the area of alternative investment funds, therefore, is limited and, more importantly, often only indirect.

Through both rules of direct application to fund managers and the indirect influence that can be exerted on regulated firms through the adoption and promotion of “best practices” on a voluntary basis, financial regulators can significantly impact the day-to-day operation of private equity and hedge funds. However, such influences can be exercised by such regulators only within the natural limitations that exist due to their limited resources and competing agendas and the needs that exist across the entire financial landscape.

One thing that quickly becomes apparent when examining the numerous regulatory reforms that are currently being attempted
on both sides of the Atlantic in recent years is that the attitude of regulators has changed significantly during the global financial crisis. Although many critics have attempted to draw the government’s attention to issues raised by the rapid growth of private equity and hedge funds over the past two decades, the unravelling of national and international markets in the autumn of 2008 meant that government officials had an opportunity to reconsider their positions. And many of them did.

To take one such senior figure as an example, the passage of a few years would appear to have led to a significant rethink in Timothy Geithner’s views on the subject of alternative investment funds, or perhaps it was simply a change in his job title. On October 18, 2005, Geithner provided the standard, enlightened view on these funds, while serving as President of the Federal Reserve Bank of New York. “Hedge funds, private equity funds and other kinds of investment vehicles help to dispose risk and add liquidity.” Six years later, on October 14, 2011, when he was serving as US Treasury Secretary, Geithner greeted the prosecution of several hedge fund managers for various trading infractions in a much more confrontation tone. “You’ve seen very, very dramatic enforcement actions already by the enforcement authorities across the US government, and I’m sure you’re going to see more to come. You should stay tuned for that.”

Of course, to be completely fair, no champion of alternative funds, no matter how enthusiastic, would ever go so far as to support insider trading or illegal market abuse. Consistent enforcement of the “rules of the game” ultimately benefits all market participants. However, the change in tone is still quite significant. In a small way, Geithner’s drift reflects a larger shift among many in government from a more neutral stance of private equity and hedge funds to a more suspicious view. In light of this heightened focus, alternative investment funds and their managers have had to adapt to the new world around them.

Private equity and hedge funds have evolved to fill particular needs in the financial markets. Those needs center on enabling
experienced and sophisticated investors to access talented investment professionals, while ensuring that retail investors retain the protection of detailed rules and regulations designed to prevent fraud and promote transparency. The quality of investment advice, whether provided directly to a client or indirectly through a fund, is very important both to the financial markets generally as well as to each individual who benefits or suffers as a result.

Of course, there is a necessary element of market risk here: every bad outcome suffered by an alternative investment fund is not necessarily proof of incompetence or malfeasance. Similarly, not every superlative return generated by a fund is proof of excellence or fair dealings. Nonetheless, investors must take steps to better protect themselves from the many types of “management risk” that they face, including the malfeasance and negligence of the fund managers themselves.

The historic status of private equity and hedge funds as (largely) unregulated arrangements is based on the explicit assumption that their participants have adequate knowledge and negotiating leverage to protect their interests. The occurrence from time to time of investor protection failures in these funds, however, raises the awkward question of whether this assumption is correct in all cases.

As commercial ventures, these funds – and the individuals who establish and manage them – are seeking to generate profits through their investment activities. In this regard, they are similar to other businesses that raise capital from investors and seek to generate profits from, for example, building and selling a better widget than their competitors. However, profiting from the mispricing of risk in multiple-currency financial derivatives, or from the fact that a particular supermarket chain is undervalued, are harder for people outside the enclaves of Wall Street or the City of London to understand. Difficulties that everyday citizens (and voters) have with evaluating the merits of the most well-known financial services firms are multiplied when the challenge is to form a judgment on the long-term value provided by unknown,
entrepreneurial firms who engage in financial transactions that are far removed from their own everyday lives.

The following chapters will attempt to address several of the key issues that arise when trying to establish a more complete and detailed understanding of private equity and hedge funds. By giving greater context to what these funds really are and what they seek to accomplish, a more accurate judgment can be made about whether these funds are being effective and delivering on their promises to their investors, as well as whether the overall financial markets and economy actually do benefit from their activities, like their champions claim.