The Institute for Governance
of Private and Public Organizations

HEC MONTRÉAL

Concordia University
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Hedge Funds and Private Equity Funds: Myths, Facts and Policy Challenges

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Value-creating governance

Agenda of Presentation

1. Preliminary remarks
2. Hedge Funds
3. Private Equity Funds
4. Policy Implications

In the Old Days….

1. Shareholders did hold their shares for a considerable period of time
2. New shareholders were few during any period of time
3. Limited use of derivative products
4. Short selling of shares-rare and viewed as an aberrant practice
5. Shareholders on the record date would still own their shares by the time of the annual shareholder meeting
6. The buying of votes was rare

New Realities of Stock Markets

- high stock churn rate

Average annual share turnover *	
1960	7 years
1992	2 years
2006	7 months

** For NYSE-listed companies (Porter, 1992; Odland, 2006)*

New Realities of Stock Markets

- high stock churn rate

Canadian corporations average holding period **	
Bombardier (class B)	12 months
National Bank	16 months
CGI Group (class A)	10 months
Jean Coutu Group (class A)	18 months
Alimentation Couche-Tard (class B)	13 months
Alcan (before the offer of purchase)	6 months

*** Source: Allaire, Y. et M. Firsirotu. « À qui appartient l'entreprise? ». Revue Forces, Juin 2007.*

New Realities of Stock Markets

- high stock churn rate and short holding period
- massive short selling and stock lending, resulting in significant empty voting
- vote buying activities for record date capture
- huge volume of stock derivatives and hedging strategies

Realities of Contemporary Stock Markets

- **As a result, the basic assumptions underlying "corporate democracy" may be questioned:**

Are these transient share-flippers really the owners of publicly traded corporations ?

" Tourists don't vote ! "

" Gamblers don't own the casino ! "

The huge volume of share trading by hedge funds is a major contributing factor to these developments

2. Hedge Funds

Some Caustic Views of Typical Hedge Fund:

‘’ Short, Swap and Foment, LLP ‘’

“ The sleaziest show on earth.”

Forbes 2005

‘’ A compensation scheme, dressed-up as an industry ‘’

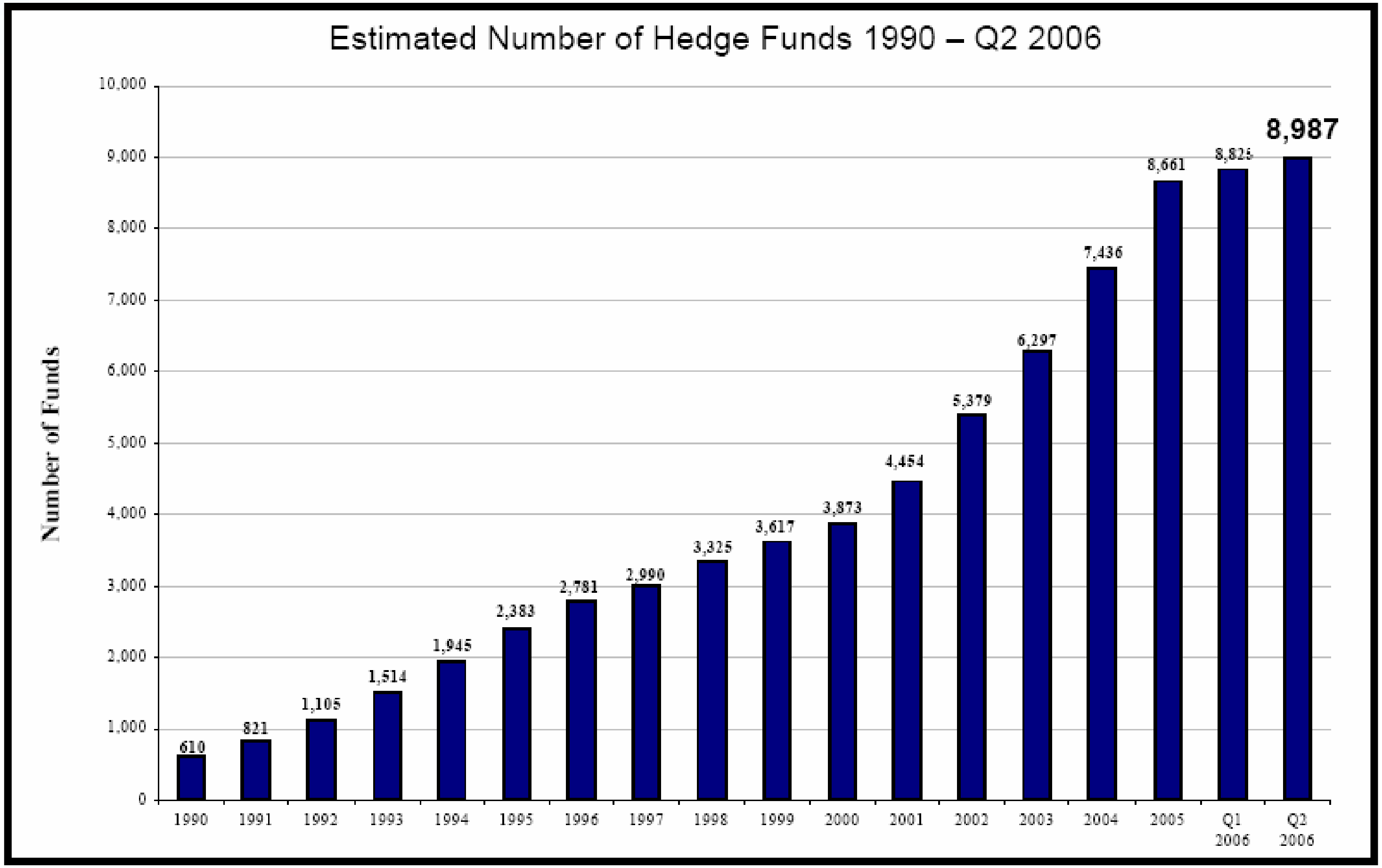
Warren Buffet

“What’s important when you are in that hedge fund mode is not to do anything remotely truthful…you must <u>foment</u>, that is create a false impression about a company in order to drive its stock one way or the other, which is blatantly illegal..”

Jack Cramer,

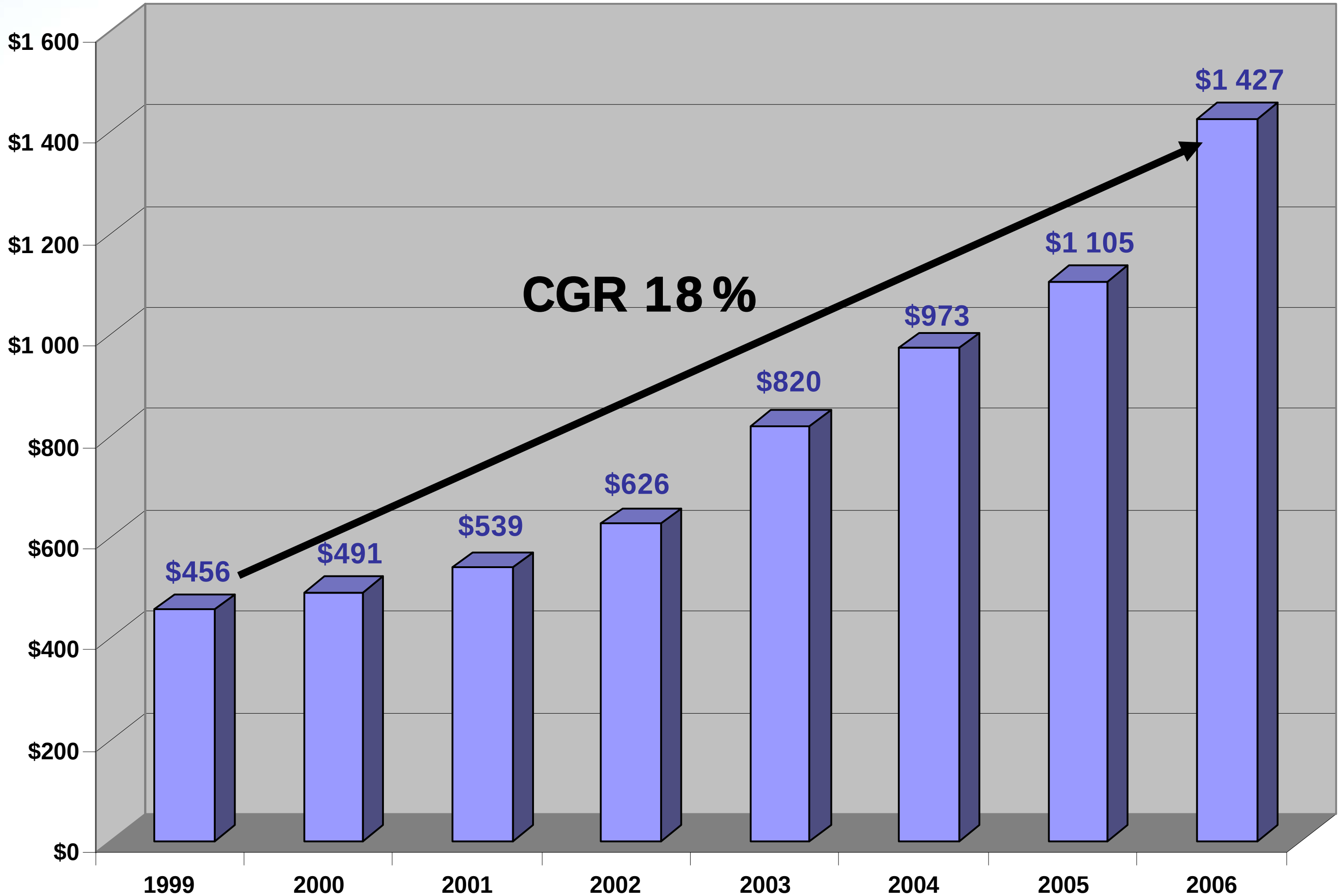
CNBC host and former hedge fund manager

Estimated Number of Hedge Funds 1990 – Q2 2006



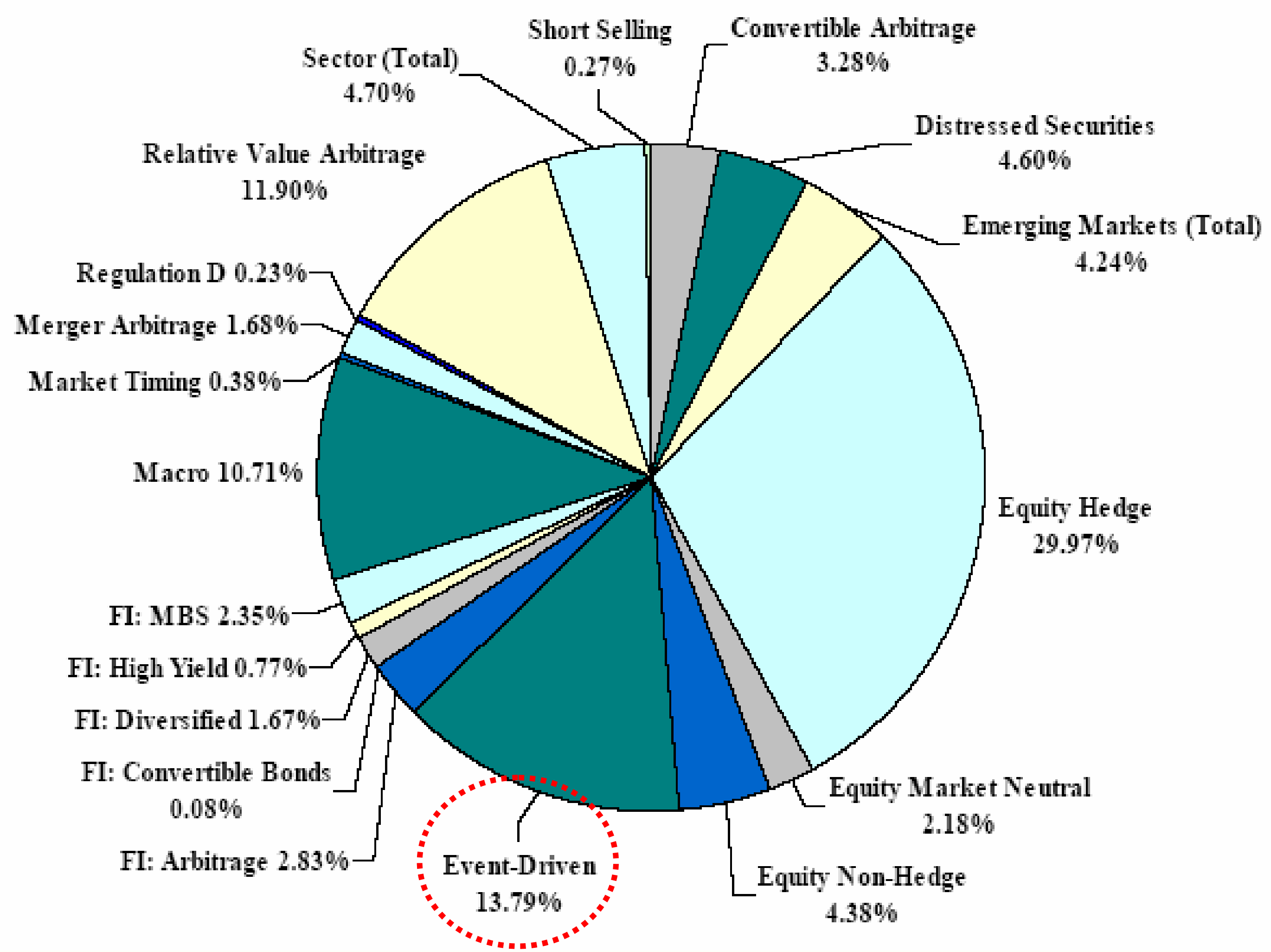
Source: HFR Industry Reports, © HFR, Inc. 8/21/06, www.hedgefundresearch.com

Hedge Funds Assets under Management



Source: HFR Industry Reports, 2007

Estimated Hedge Funds Strategy Composition Q2 2006



Source: Alpha Magazine Hedge Fund 100, 2005 & 2006; Absolute Return, 2006

Hedge Funds are Playing a Major Role in the Transformation of Shareholding

- **Equities account for approximately two-thirds of their investments**
- ***Represent between 30% (Moyer, 2006) and 50% (Campos, 2005) of all transactions on the New York and London Stock Exchanges***
- **In 2006, hedge funds have significant** *(5%+)* **stakes in 38% of the world's public companies (Skadden, Arps, Slate, Meagher & Flom, 2007)**

Why are Investors Flocking to Hedge Funds?

The holy grail of “ALPHA”:

The quest for ”absolute return”, that is, returns higher than should be expected for the risks taken

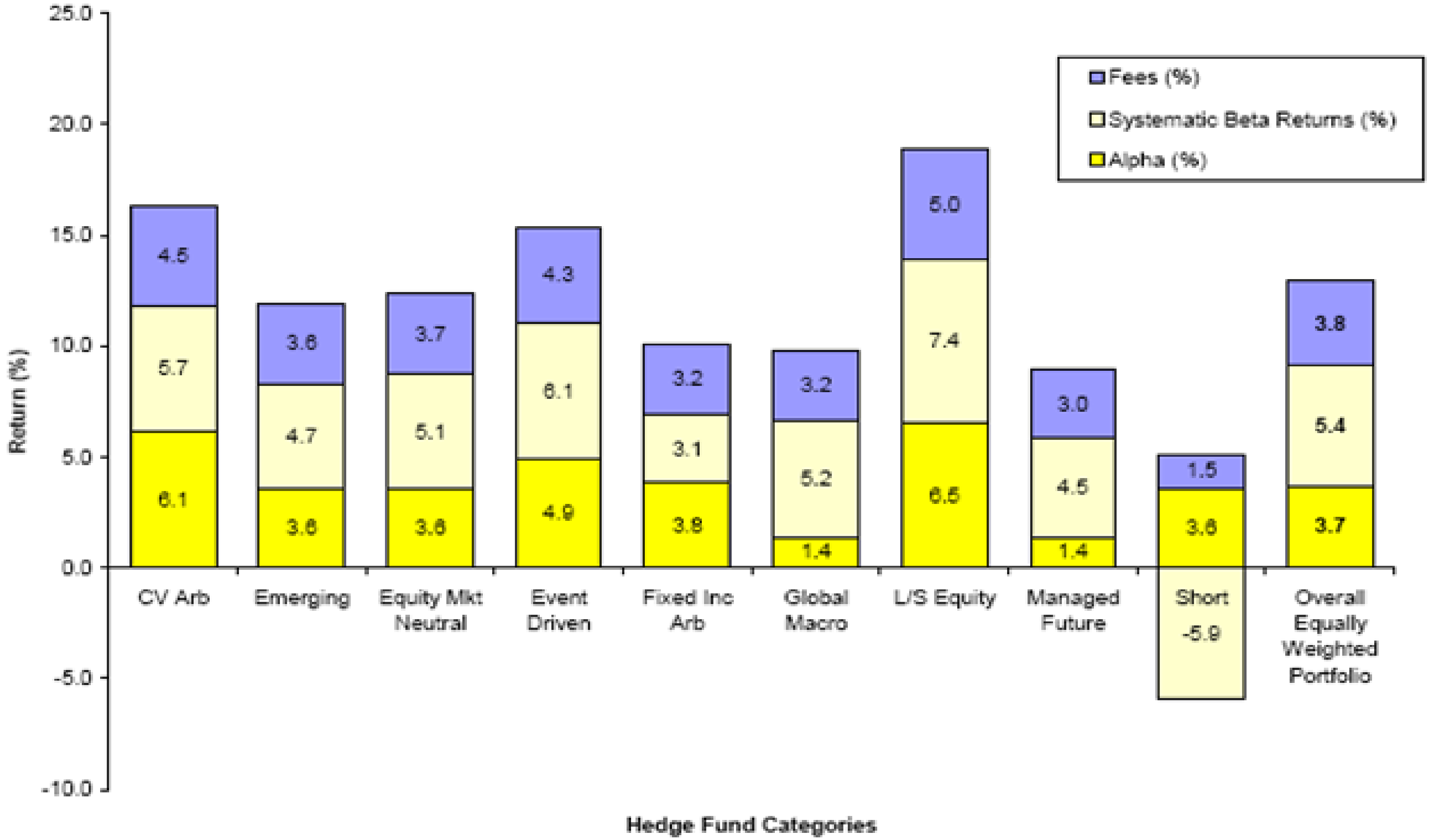
Alpha is the Holy Grail of Investment

" Alpha is the nirvana all active managers claim they can consistently produce for their clients…"

"…positive alpha is still difficult to identify beyond doubt. Benchmarks are mushy, risk measurements are arbitrary, and what we want to classify as alpha, or beating the benchmark, is often just the return to systematic risk, or beta."

Sanford C. Bernstein (May 2007)

Source of Hedge Fund Returns: Alphas, Betas, Costs
(1995 - March 2004)



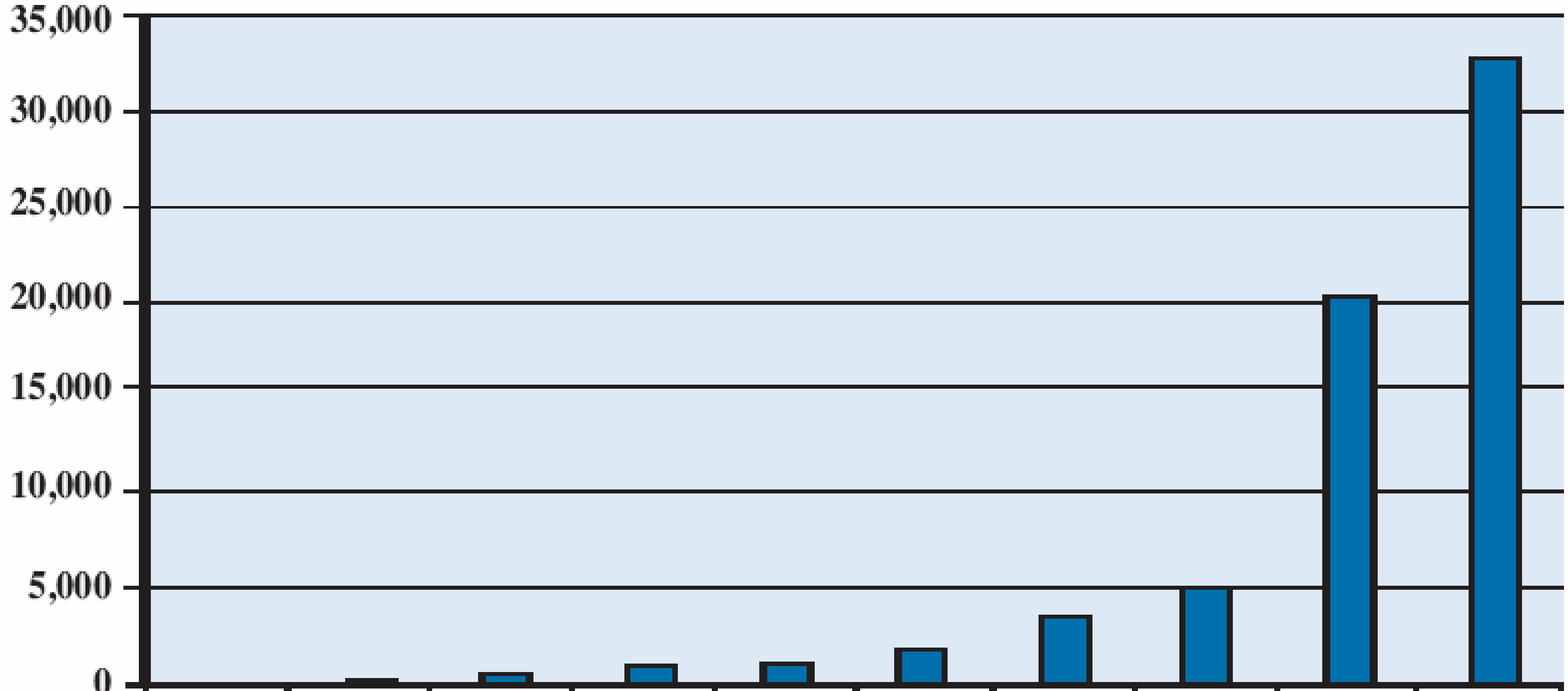
Ibbotson, Chen (August 2005)

How do Hedge Funds Produce "Alphas"?

- **They claim to have developed proprietary trading/investment strategies, to have unusual skills at spotting *"market imperfections"***
- **They enhance the liquidity of markets and thus reduce the cost of capital**
- **They take risks, more of it and faster, than other players**

Credit Derivatives:
The New Game of Hedge Funds

***(and the fastest growing financial market)* ($bn)**

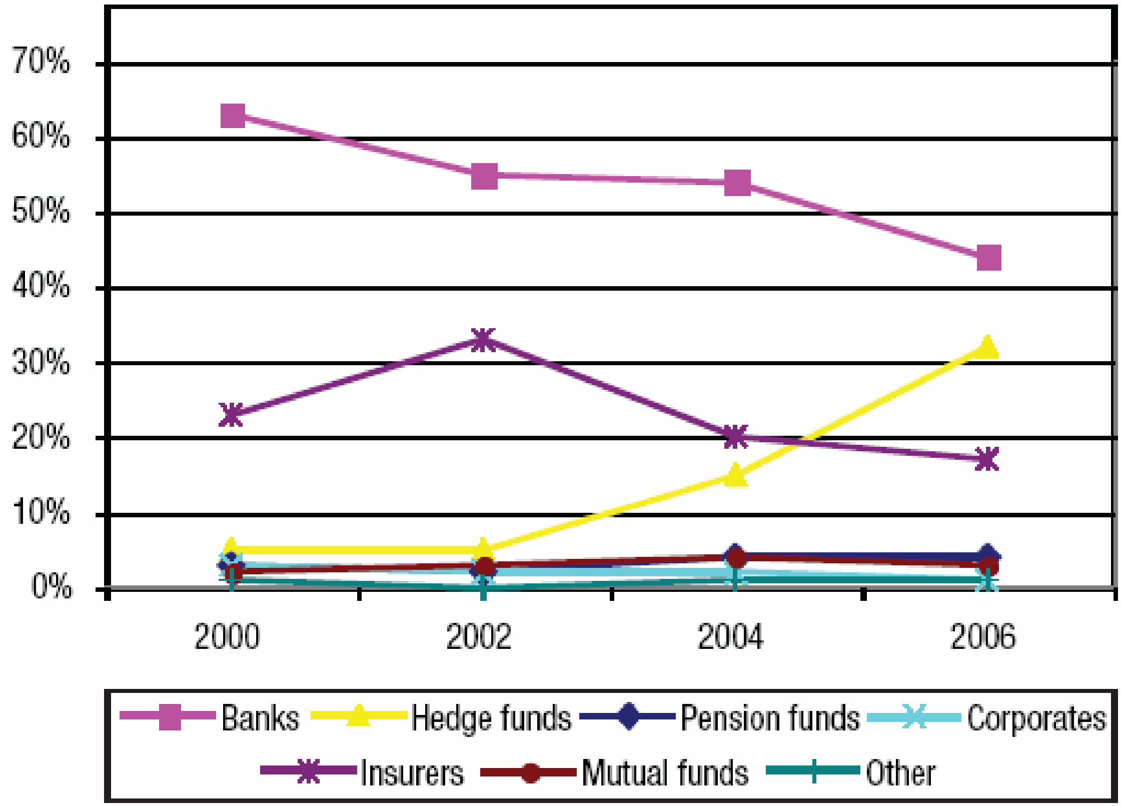


	1996	1998	1999	2000	2001	2002	2003	2004	2006	2008 (est.)
USD (bn)	180	350	586	893	1,189	1,952	3,548	5,021	20,207	33,120

BBA Credit Derivatives Report 2006

Credit Derivatives:
The New Game of Hedge Funds

Sellers of Credit Protection



Source: BBA – Credit Derivatives Report 2006

Hedge Funds as ‘’Activist Investors’’: Another New Game

- Some 200 hedge funds with about $ 200 billions in assets *(Clifford, 2007)*
- Very fast growth over the past 3 to 5 years

Hedge Funds as Activist Investors: What do They Want?

Four typical requests:

- Selling the company **(33% of cases)**
- Unbundling-selling divisions, assets, etc. **(32% of cases)**
- Disgorging cash-special dividends, share buy-back **(unspecified number of cases)**
- Changing strategy and/or management **(unspecified number of cases)**

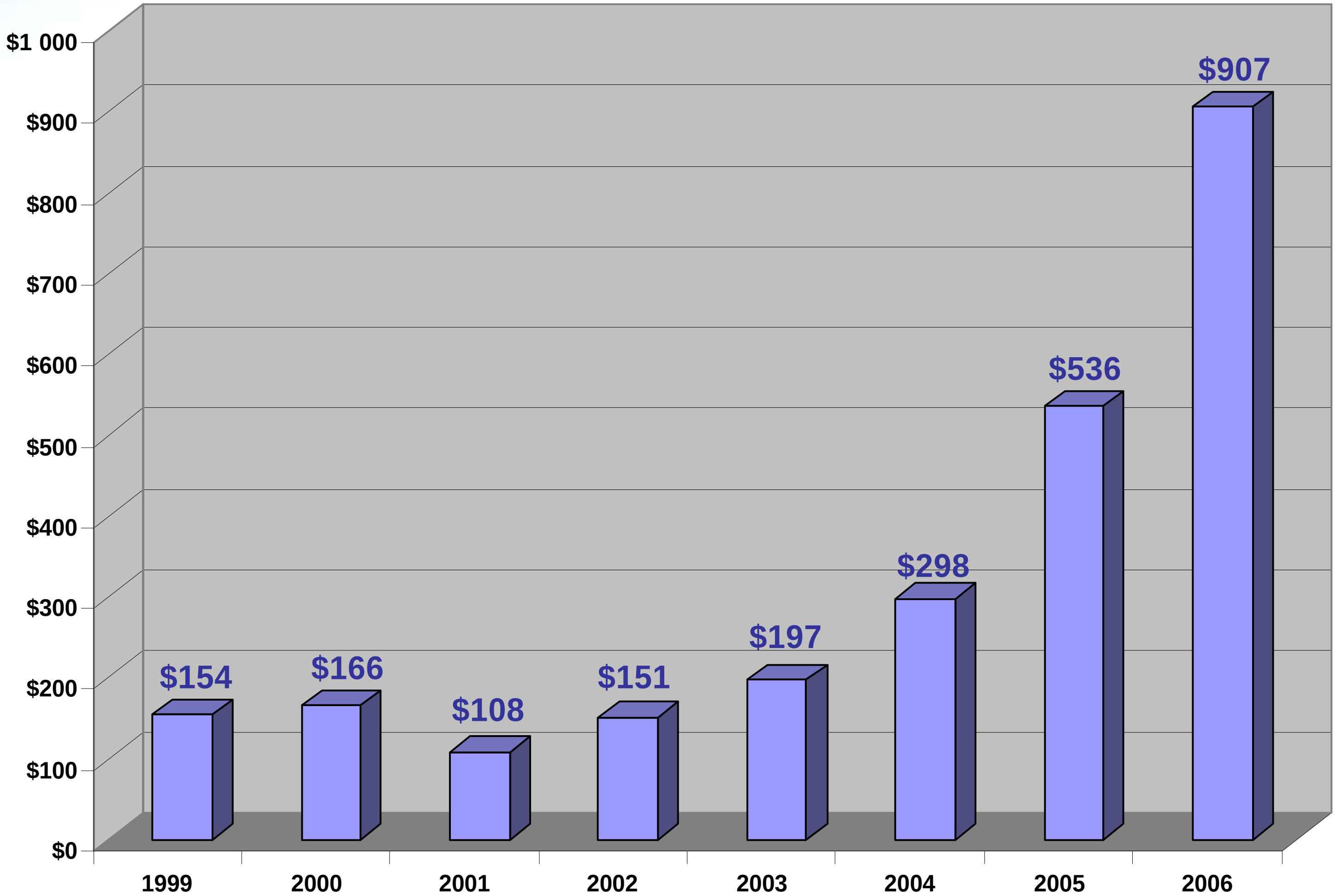
Source: Bratton, 2006

Risks of the Hedge Funds Phenomenon

- "Market imperfections" often means navigating in murky waters of insider information, of "fomenting news" etc
- They are the worst governed of organizations, opaque, very secretive and resistant to efforts to monitor and regulate them; yet, institutional investors pour a great deal of money into these funds!
- Their reward system is so outlandishly generous that it's bound to produce fraud, trickery, strategy drift and a search for any way to produce returns (real or phony)
- Their targeted return actually raises the cost of capital and commands a short-term perspective from corporate management
- Their number and size now mean they often are the decision-makers on mergers and acquisitions (e.g. Falconbridge, Alcan, etc)
- Their high leverage is a source of real concern

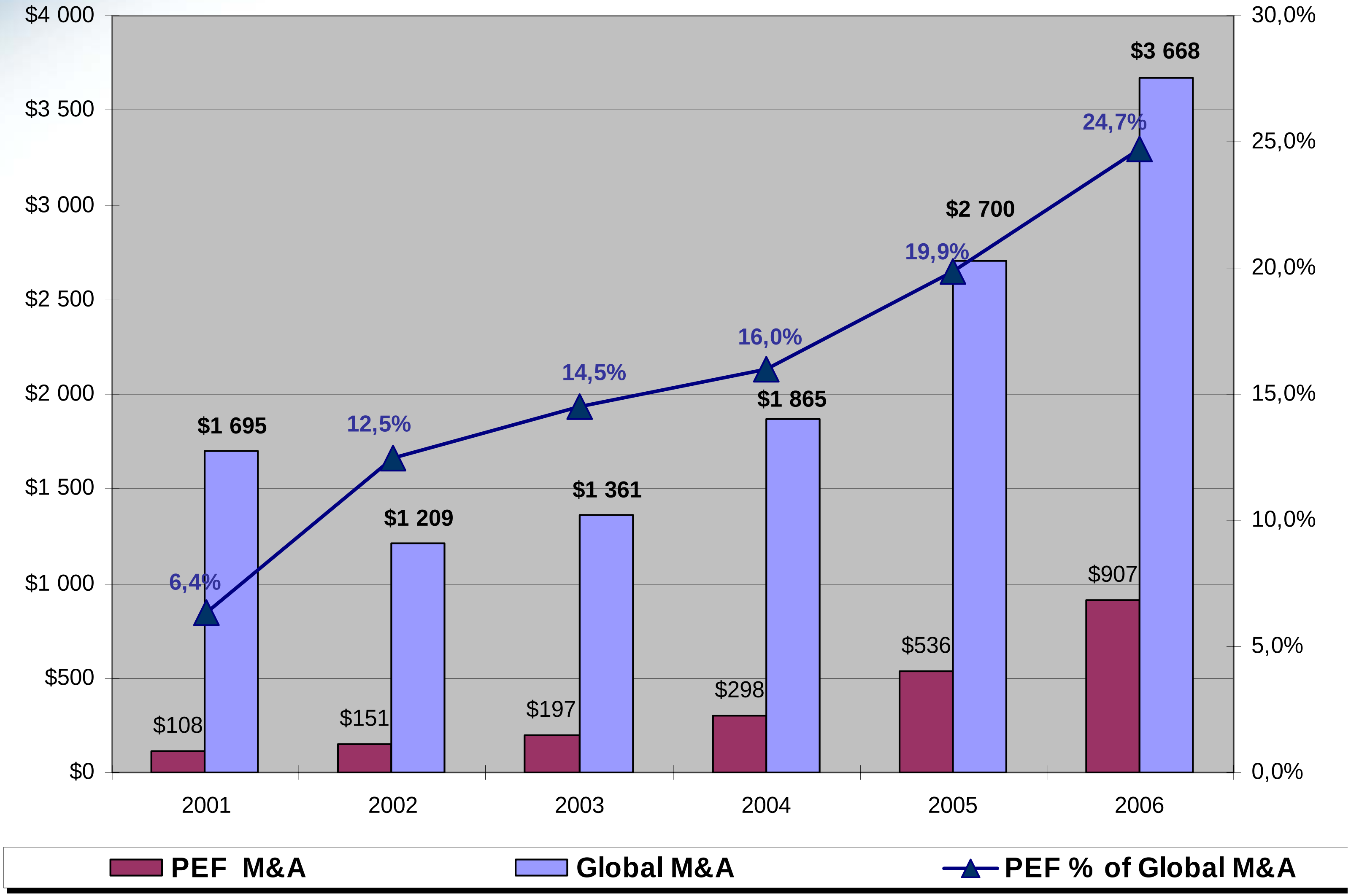
3. Private Equity Funds

Dollar Volume of Private Equity M&A



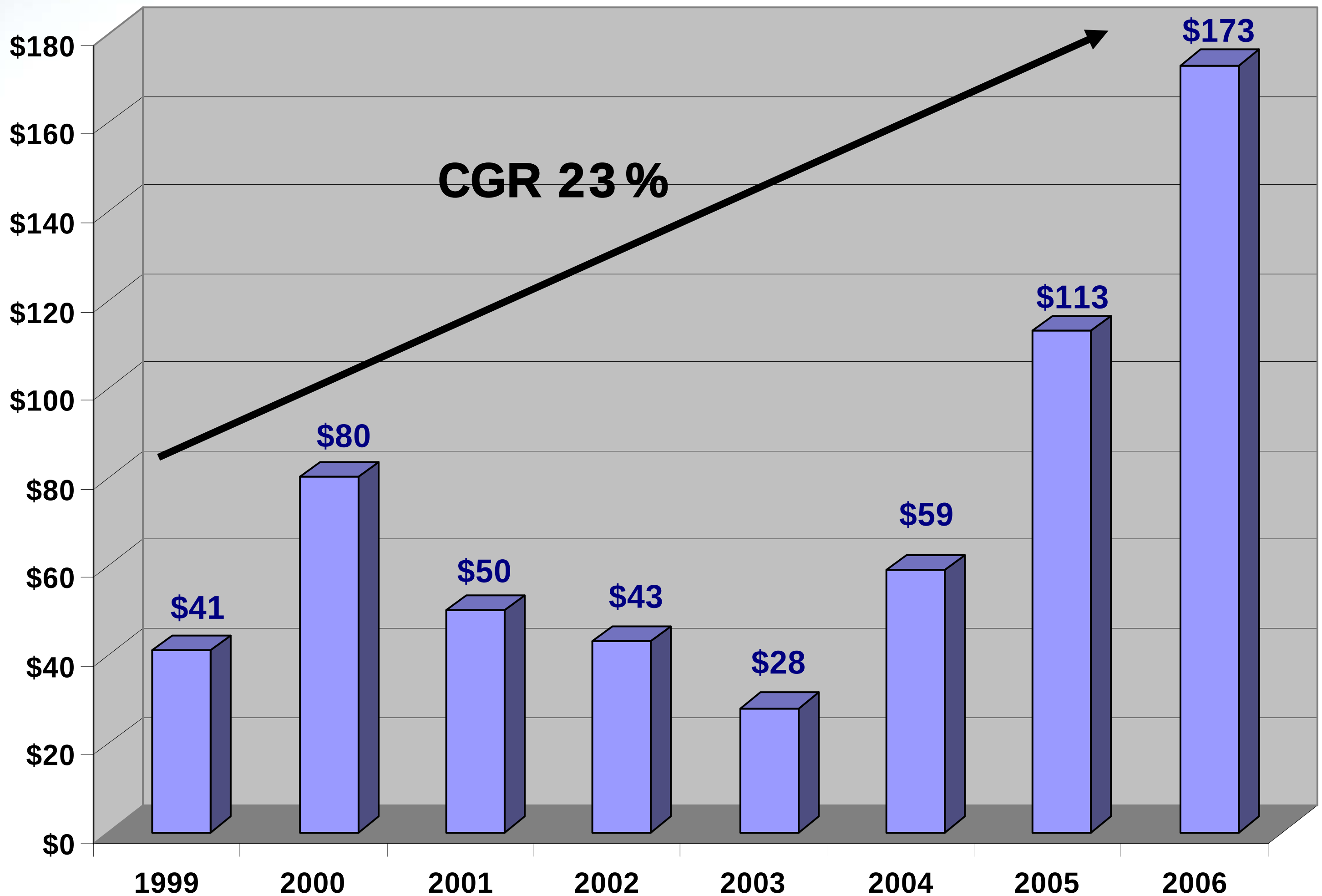
Source: Thomson Financial, 2007

Private Equity Funds M&A as a Fast Growing Portion of Total M&A Activity



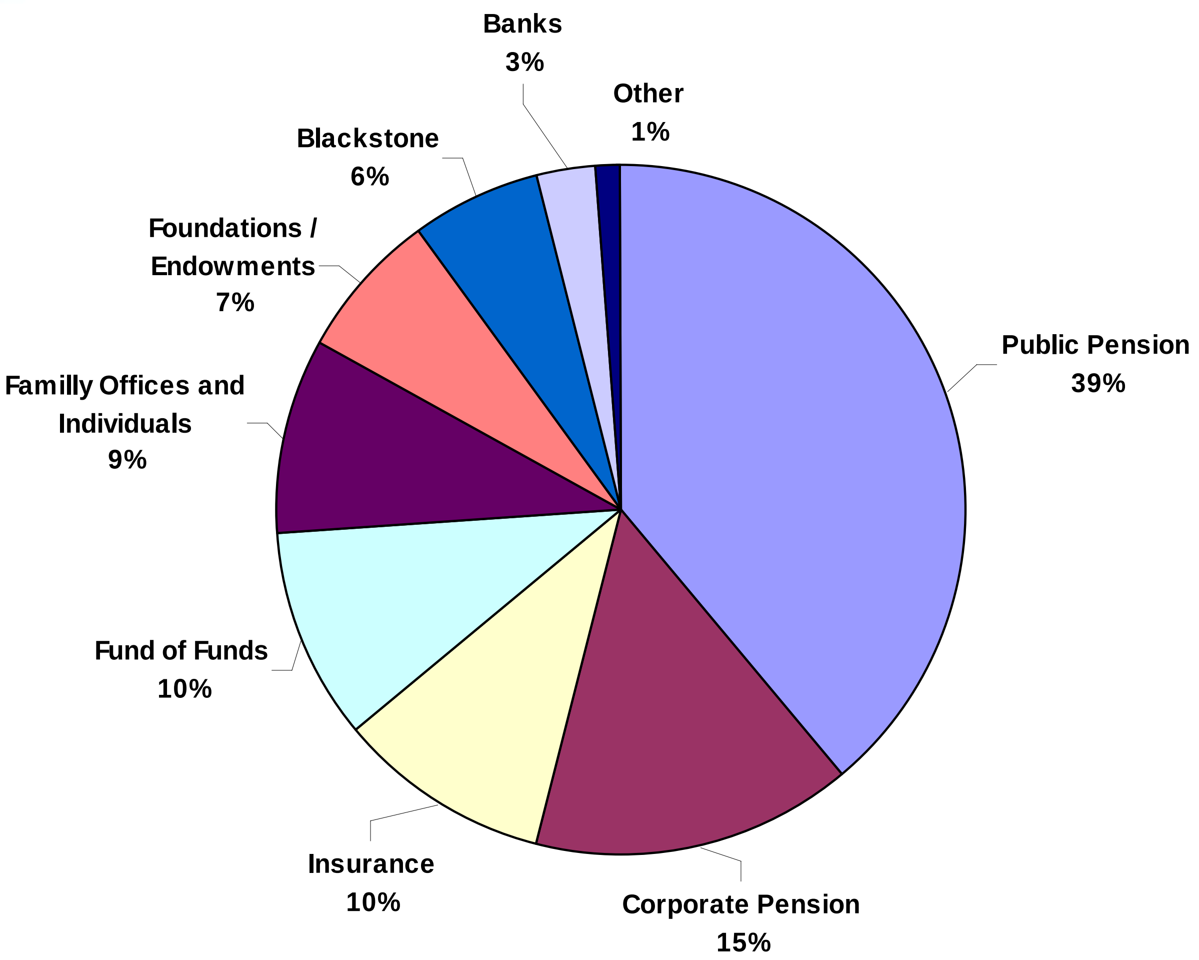
Source: Thomson Financial, 2007

U.S. Corporate Private Equity Funds Raised



Source: Private Equity Analyst Plus , 2007

Example of Blackstone PEF Investors by Category



How Private Equity Funds Claim to Create Value ?

- Hire and pay managers to act like owners
- Define a clear 3-5 year "investment thesis"
- Make capital work hard
- Measure only what drives value
- Make the centre an active shareholder

Source: Bain, 2006

How a Typical Private Equity Fund Actually Generates High Returns: *Buy, Strip and Flip, LLP*

Three sources or "market imperfections":

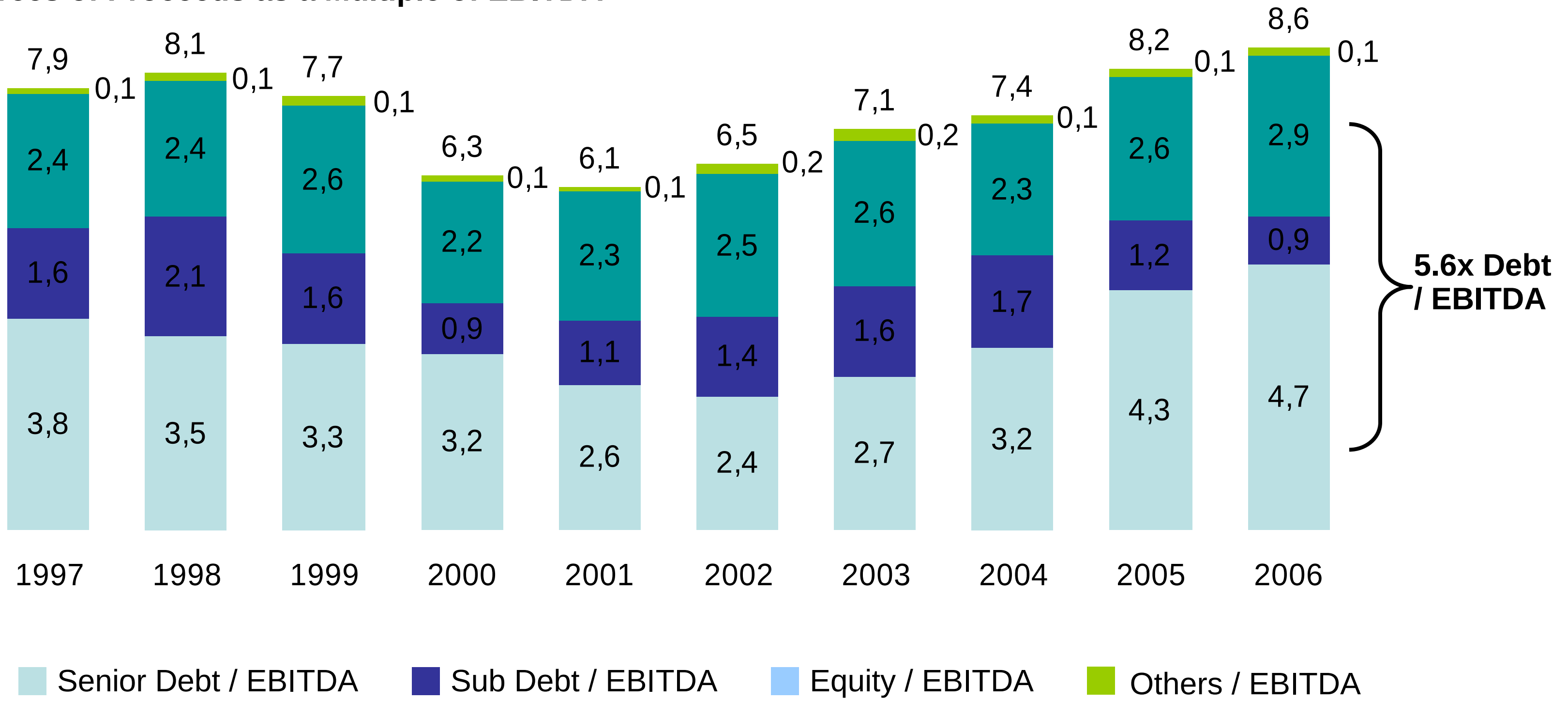
- **A fiscal "imperfection"**
  - **buying the company with borrowed money and getting the tax payers to subsidize the transaction; actually a transfer of wealth from stakeholders to new owners**
- **A governance "imperfection"**
  - **replace fiduciary forms of governance, which are weak and sub-optimal, particularly so after SOX and such; reward lavishly management for 3-5 year performance**
- **A covenant "imperfection"**
  - **transfer of wealth from holders of old debt**

Average Purchase Prices and Leverage Increasing

Purchase Price Breakdown (Deals Over $50MM)

Purchase price and leverage levels are at their highest point in almost 10 years
- **In part driven by need of private equity firms to deploy capital**
- **Supported by huge liquidity and low interest rates**

Sources of Proceeds as a Multiple of EBITDA

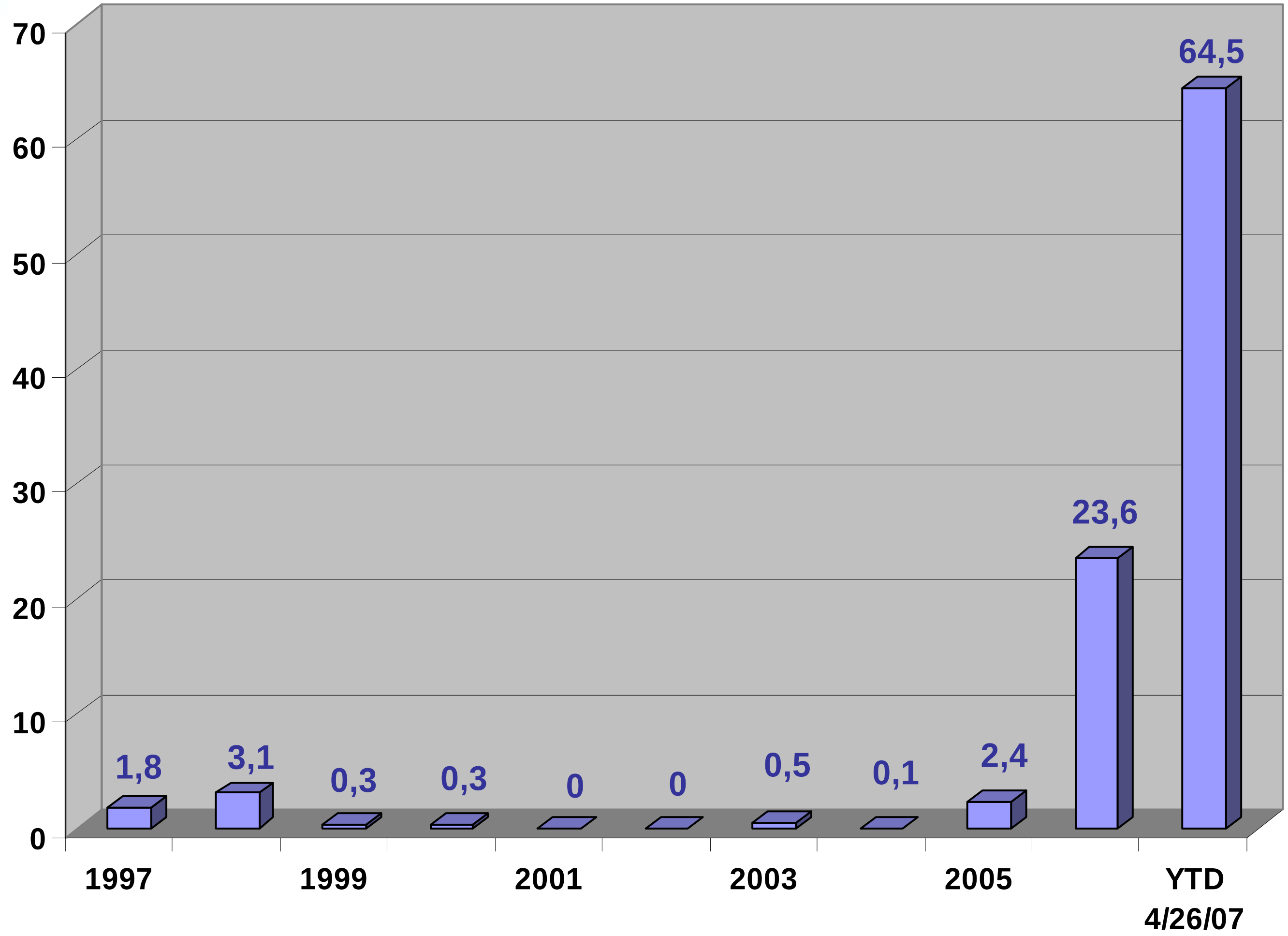


Source:
S&P LBO Review

A New Phenomenon: the Reduction of Debt Covenant
(covenant-light debt)

- **Banks have lost their monopoly on lending**
  - **because of competition from non-bank lenders such as hedge funds, they can no longer impose strict restraints on borrowers.**
- **A more developed ability to sell loans**
- ***The growth of the credit derivatives market (where hedged funds are major players)***
- **Many non-bank lenders do not want to get involved in the regular waivers and consents needed to allow a borrower with full covenants to carry on their business.**

A New, Troubling Phenomenon: the Covenant-lite Lending ($bn)



Source: Standard & Poor's LCD Covenant-Lite Activity (4/26/07)

Privatization of Public Companies: Any Lasting Benefit?

- Companies managed entirely for debt-reduction and for an IPO (or sale) within 3 to 5 years. No projects or strategic investments with a time horizon longer than three years will be undertaken
- Whatever improvement in efficiency stemming from better governance will not last as company is returned to the stock market and the same limited form of governance

4. Policy Implications

Policy Implications

- **Both Hedge Funds and Private Equity Funds:**
  - Promote, in different ways, a short term approach to the management of business
  - Promote unfettered trading in the control of companies, ***as if they were a commodity***, a metal, or a piece of commercial real estate
  - Influence the industrial structure and business ownership of a country
  - Combine their actions in ways that may increase the risk of system failure (e.g. both are highly leveraged; PEFs can borrow with fewer covenants because lenders can buy credit insurance from.. hedge funds; hedge funds agitate for a company to be sold off.. PEFs show up as buyers)

Policy Suggestion I

- **Granting the full and immediate rights of corporate citizenship to shareholders upon their appearance in the rostrum of shareholders, does not make sense anymore**
- **Every democracy imposes a minimum period of time before a newcomer acquires the full rights of citizenship, particularly the right to vote**
- **Corporate democracy likewise should call for a modicum of commitment from a shareholder before he or she can influence the destiny of a company**

Policy Suggestion I

Encouraging committed, stable and loyal shareholding

- **One-year holding period before right to vote**
- **Other measures to reward shareholder loyalty (?)**
  - **Multiple votes after a number of years**
  - **Increased dividend after a suitable holding period**
  - **Capital gain tax reduced as a function of holding period**

Policy Suggestion II:

Enhanced board responsibility in takeover situations

Governance and Takeovers (USA)

	1990	1993	1995	1998	2000	2002
Entrenchment Provisions:						
Board Classification	0.565	0.582	0.595	0.575	0.580	0.600
Poison Pill	0.513	0.535	0.530	0.512	0.544	0.550
Super Majority	0.169	0.182	0.173	0.142	0.154	0.158
Golden Parachute	0.497	0.527	0.535	0.554	0.637	0.674
Other Provisions:						
Limited Special Meetings	0.239	0.287	0.310	0.331	0.365	0.479
Blank Check	0.766	0.794	0.847	0.874	0.890	0.903
Dual Share Classes	0.076	0.082	0.083	0.107	0.119	0.118
Business Combination Law	0.850	0.884	0.889	0.903	0.913	0.916
Delaware Incorporation	0.479	0.505	0.527	0.574	0.575	0.605

Source: Investor Responsibility Research Center (IRRC)

Policy Suggestion II

Mécanismes de défense contre les prises de contrôle: une comparaison

	Canada	États-Unis
Double classe d'actions (% des entreprises cotées)	15%	12%
Cadre juridique permettant au conseil de rejeter une offre d'achat	0	31 États
Interdiction de combiner les actifs d'entreprises fusionnées pour une période de temps variable	0%	92%
Conseil élu pour trois ans, avec un tiers chaque année	ND	55%-60%

Source: Allaire, Y. et M. Firsirotu. « À qui appartient l'entreprise? ». *Revue Forces*, Juin 2007.

Policy Suggestion II

Making boards accountable for the long-term wealth of the company

- **Board legally authorized to reject hostile takeover attempts if not in the long-term interest of the company**
- **Respond to activist investors in a manner compatible with long run interest of the company**
- **May consider other stakeholders in its decision-making**

Policy Suggestion III

Capping the interest deductibility for income tax purposes

- **Interest on any debt above, say, 60% of capital structure would not be deductible for tax purposes**

Other Policy Suggestions

Tax income of hedge funds and private equity funds as operating income not as capital gains

Better disclosure of share lending for purposes of record date capture

Shorten period between record date and date of annual meeting; make better use of Internet for proxy voting

Conclusion

- The long-run welfare of societies and the economic vigor of companies are more important than the spurious lure of “shareholder value” and the freedom to practice financial legerdemains
- A company is not just a piece of property, but a social system with an economic finality
- Boards of directors should have a fiduciary responsibility for the long-term welfare of the company, which includes a moral responsibility to other stakeholders
- Governments have the power to shape a country’s economic destiny; let them use it wisely.

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