The New Mexican/Real Money June 8, 2004

Hedge Funds

A PRIMER ON PRIVATE EQUITY FUNDS

Beginning this month, I would like to start introducing investment concepts which may_be new to some people. The subject of today's column is private equity, one of the major components of alternative growth vehicles. Because of their likely increased importance if traditional stock markets move sideways for an other extended period of time, I feel it is important for all investors, not just those considered "sophisticated", to be aware of the pros and cons of the different forms of private equity. As interest rates and inflation rise, alternative investments give investors a chance to gain appreciation or earn income in a completely different way than publicly traded stocks, bonds, and mutual funds.

"Private investments" are so-called because, as opposed to publicly traded securities, they are not sold in auction markets, like the New York or American stock exchanges, nor can they be traded over computers. So far, at least, they are subject to far less government scrutiny. It takes more time to research opportunities to buy into or sell out of private investments and when and where you can transact changes in private equity holdings is almost always more limited, sometimes severely so.

One result of the much lower level of regulatory requirements on private investment vehicles is that investors are deemed competent to tell for themselves if they can handle the higher risk. There are restrictions that require a certain level of personal wealth before one can get involved in direct private equity investing. It takes more upfront work to decide because the investments are often complexly structured, and it is hard to change your mind once you are in so you better have a very long term frame for the money or it is likely not an appropriate use of funds, the investments themselves, because they are in private companies, are much more dependent on local managerial talent and ability, so be aware of the specific targeted type of risk in private equity offerings.

Private equity generally connotes buying stock in a business that is small. All stock, public or private, represents sharing ownership with others, and private stock means that your circle of friends, managers and co-owners is likely to be small. There are restrictions on the number of people who can be brought in from outside to participate with the founders in owning portions of the company.

People who get it right, who can find and negotiate their way as investors in private businesses can make a lot of money no matter what the overall stock market is doing at the time, The odds of success for small companies are typically low, on the order of one or two survivors out of ten attempted businesses. The occasional success of companies like Amazon.Com, Google, Krispy Kreme, and Starbucks, are highly rewarding to "early" investors, but the roadside is littered with numerous examples of companies with great ideas that did not make it. Some of the reasons for failure include shortcomings in management ability (egoism triumphing over good common sense), inability to adapt to changing competitive environments, and inadequate resource planning for financial contingencies.

A key player in creation of a successful private equity investment is the professional analyst who sifts through the many candidates who are always looking for outside investors' money. When enough suitable opportunities to buy into private companies present themselves, private equity firms have started to combine a variety of private company stock investments into a "fund". Funds are supposed

to take responsibility for everything on behalf of the small investor from doing the initial research to helping their client investors and client companies do all the required paper work. Another function is the oversight and review work on the companies themselves. Eventually, when the newly buffed up company is ready to go out on their own, fund managers should be responsible for the "exit" work, or getting the early investors' money back plus an acceptable rate of return.

The exit or divestiture of a particular business out of a diversified portfolio of private equity holdings can happen in a variety of ways. Most people consider "going public" as the most profitable way but this is not always the case. Some companies are very successfully sold to their employees or line managers. Other avenues are to sell the company to a competitor, a peer, or a larger company that wants to enter the company's line of business.

Recently, a renewed interest in local business ownership has led some innovators to try to bring about selling private stock to community minded investors (more on this subject in future columns). There is even an interest on the part of some state and municipal governments to buy stock (or equity) in local companies that would benefit the local community in terms of job creation, quality of life, and environmental sustainability. Pension funds and many college endowment funds can and do participate in private equity.

There are, however, negative attributes to private equity. These downsides include, but are not limited to high risk, low liquidity, lack of transparency, loose regulation, and reliance on a few key managers. Commensurate with this risk is the fact that investing in private equity, either directly or through funds with integrity, does give investors a chance to make very large returns. By targeting a specific management style, industry, region, or stage of business, one can have greater certainty that one's personal brand of ethical screening will be applied than exists with publicly traded companies.

Early investors in Ben & Jerry's, for example, could see the benefit of their stock investment on the lives and fortunes of organic dairy farmers in Vermont. Businesses are complicated beasts. There are numerous examples of companies that exhibit creativity, excitement and personal commitment of the founding management team and these are a few of the initial criteria to use when searching out private equity candidates.

Private equity funds, like hedge funds (another upcoming column topic) are typically available only to wealthy individuals and institutions, as they often come with high minimum investments of $100K, $250K or even $1 million per participant. Due to Wall Street's excitement that investors with smaller amounts would be attracted to these possibilities, a new breed of private equity funds has arrived on the public stock exchanges. The funds are structured either as mutual funds or as closed end funds which makes them look like traditional stocks.

Several big name private equity firms in New York are rushing forward with these new issues. Their hope is that there are enough members of the public who have smaller amounts: two; ten or twenty-five thousand dollars which so invested will allow the investment firms to reap large fees as the funds are allowed to borrow money using investor money as collateral and then they charge fees on the investor funds plus the borrowed funds! Quite a racket.

The big question is whether small investors will get the same quality of deals as the bigger players and not just the second or third rate deals. Remember that private equity funds have very good (and expensive) lawyers working for them. The fund's literature contains carefully drafted disclosures that say that there is no guarantee that investors in the fund that is available to the public will be participating in the same investment opportunities as their larger clients.

As a result, there is a conflict of interest for managers of these private equity funds. If they don't have to give the publicly traded fund the same investments as their big money clients, who will take precedence? The fund prospectus acknowledges these pitfalls, but as usual, it is the individual investor who bears the burden of vigilance.

Private equity is an essential part of our economic system as small companies often need outside investors, who are attracted by these direct stock sales, to give them the ability to grow. My thought is that these publicly traded funds may not be the way to go for small investors, depending on the ethical structures governing the fund under consideration. Thorough investigation is essential to making a sound decision.

Standard fees for private equity are a 2% to 3% management charge per year plus 20% of the profits. Again, watch out for the ability of a fund to borrow, as this can increase the fund managers take home pay while heightening investor risk and returns. Private equity is a great concept that I fully embrace. More particularly, local, sustainable private equity is an area of extreme interest and relevance to our country's ability to create meaningful jobs and cohesive communities. As is true for most investment propositions, proper execution is key. There is no substitute for doing your homework.

Rob Rikoon is the CEO of Rikoon Carret Wealth Management Group, a full service financial planning and investment management firm located at 510 Don Gaspar, Santa Fe, NM, 87505, Tel (505) 989-3581. Email: rrikoon@aol.com.