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Interest Growing In Private Equity Investing

In today's turbulent times, there is a renewed interest in local business investing. This has led some innovators to try to figure out how to bring private company stock to community-minded investors. This is not easy as the government has a multitude of regulations that seem to be organized around the principle of keeping people from pooling money in creative ways to help each other out. I guess they figure this is an area ripe for abuse and, given the long history of investor scams, they are partially right! Some friends of mine and I are working on some of these issues here in New Mexico and, hopefully, our state will take the lead going forward in making community investing more friendly!

There is a growing interest on the part of the state and municipal government agencies, such as New Mexico's Small Business Investment Corporation, to invest in local companies that benefit economically depressed local communities. The reason most often given for this effort is that it is a great engine for job creation. Pension funds and college endowments also may participate in private company stock, though, so far, they shy away from most small ventures.

There are several attributes of private equity that present potential danger. These include, but are not limited to, the inherent high risk of any small company's stock, severe constraints on how and when you can get your money out, which is called low liquidity, and a lack of transparency, which means it's often hard and it takes a long time to get real financial or other pertinent information on private equity investments. Along with the risks comes the chance to make very large returns irrespective of what the stock or bond market is doing. By targeting a specific kind of private stock (equity) fund that focuses on a certain industry or a certain region, or type of business, people can have greater certainty that their personal brand of ethical screening will be applied than with mutual fund investing.

Early stock investors in Ben & Jerry's, for example, could see the benefit of their private equity investment on the lives and fortunes of organic dairy farmers in Vermont. There are numerous examples of small and mid-size companies that exhibit creativity, growth and a high degree of personal commitment on the part of the founders. There are many criteria to use when searching out private equity opportunities and if you don't find one easily, wait six months and look again as this is one of the hot areas of investing.

Private equity funds are usually available only to wealthy individuals and institutions as they often require *minimum* investments of $100,000, $250,000, or even $1,000,000 per participant. Due to the fact that there are now many investors with smaller dollar amounts, such as $25,000 or $50,000, who would be attracted to this new kind of investment, several private equity funds have arrived on the scene! Most of these funds are structured as mutual funds or as closed end funds, which makes them look like traditional stocks as they trade under a 3 to 5 letter symbol on a national exchange.

Several big-name firms in New York are rushing to the market with these new kinds of investment funds. Their hope is that there are enough members of the public who want to get in on the excitement and who won't read their literature too closely so these firms can reap extra large fees. Since many public funds are allowed to borrow money, using investor money as collateral, they can charge their management fees on all the funds. Watch out for these characters as they usually have very slick brochures!

My question is whether the small investors in public funds will get the same quality of deals as the big players. Private equity funds have expensive lawyers working for them who make sure that the fund's literature contains disclosures that say that there is *no* guarantee that investors in the fund that is available to the public will participate in the same investment opportunities as the firm's larger private clients.

This is a problem because, as a result, there is an immediate and insurmountable conflict of interest for the 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, we can guess who will take precedence when a great deal comes along. The fund's prospectus must acknowledge these potential pitfalls, so as usual, it is up to you, the individual investor, to be vigilant.

Private equity is an essential part of our economic system. Small companies need outside investors to grow, and savvy investors are attracted to these direct stock sales due to their high return potential to grow. Publicly traded funds may not be the way to participate in private equity because of the ethical issues confronting the fund and the poor track record many firms have in doing "the right thing."

The standard fees that go to private equity managers are 2% to 3% per year *plus* 20% of the profits. If a fund is borrowing money, this can increase the fund manager's pay while raising investor risk levels. Private equity is a great concept and in particular I believe the future of our middle class depends on local, sustainable private equity. Unlike government programs that try to create meaningful jobs to help communities in need, private equity is a way these communities can face these challenges directly.

The frustrations investors feel in the stock and bond market can have a productive outlet through private equity, but, as is true for most investment propositions, proper execution is the key. There is no substitute for doing your homework! In upcoming articles, I will be describing investing challenges and opportunities in private equity, especially those in New Mexico, as well as other alternative investment vehicles.

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