After Blackstone: Should Small Investors Be Exposed to Risks of Hedge Funds?

Testimony of
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INTRODUCTION

Thank you Chairman Kucinich and Ranking Member Issa for allowing me to testify before your hearing today. I am Peter Tanous, president and CEO of Lynx Investment Advisory LLC here in Washington DC. Lynx is an investment consulting firm founded over 15 years ago. We advise on assets for individuals and institutions totaling in excess of $1.3 billion. I have been in the investment business for over 40 years and I am the author of three books on investments. A fourth will be published in January 2008.

Thank you for the opportunity to share some views with you on the risks faced by investors with respect to hedge funds, private equity funds and IPO's of their management companies. As the CEO of an investment consulting firm, this is a question we deal with frequently.

I would like to make several points:

What is the difference between private equity firms and hedge funds?

What are the inherent risks to investors in owning shares in the companies that run these funds, such as Blackstone? How different are these risks from investing in other types of securities?

Are hedge funds safe for the average investor?

Should private equity firms and hedge funds be regulated by the SEC?

Difference between Private Equity firms and Hedge Funds

On my first point, I would like to distinguish between hedge funds and private equity firms. They are not the same thing. Hedge funds are investment partnerships that can invest in a broad range of investments. They can buy stocks, sell stocks short, buy options and commodities and borrow money to create leverage.

Private equity funds are generally also formed as limited partnerships. But these funds don't usually buy stocks as investments or sell stocks short. They buy entire companies that may or may not be publicly held and take them private. Often these investment firms will take measures to improve the companies and sell them back to the public through an IPO at a higher price, thus making money for their shareholders and themselves.

What both private equity funds and hedge funds have in common is that they both charge very high fees, typically 2% of assets under management (AUM) and 20% of investment profits. They also share another important feature in that liquidity is quite restrained.

Private Equity	Hedge Funds
Private equity is primarily geared towards long only investments in whole companies. The investment universe is not vast	Hedge funds can buy and sell short but generally do not buy whole companies. The investment universe and strategies available for a hedge fund is vast
They buy full control, or will at least have high level of control over the firms they invest in	Low or no control
Multi-year horizon: The assets are tied up for many years. They are truly long term investors	Shorter time horizon: The assets are not tied-up for years although liquidity is limited
Little to no exposure to derivatives	Extensive use of derivatives
Holdings are transparent (An investor knows what the fund owns)	Holdings information is guarded and is not transparent (The investor generally does not know what the fund owns)

Both private equity and hedge funds impose limited liquidity on investors as compared to investment in the stock market or mutual funds. Private equity investments often involve a commitment measured not in days or months, but in years. One of the marquis names in private equity, Kohlberg Kravis Roberts, which also plans an initial public offering, says 73% of its assets are committed for as much as 18 years. This long-term commitment gives the firm huge flexibility to ride out tough times. And it provides a steady stream of cash from the typical 2% management fee – alongside the bigger and more volatile 20% share of investment gains.

By contrast, hedge fund investors can take their money out relatively quickly (but in a time frame generally measured in months) if performance is bad, making the underlying fee stream less secure.

In the end, success of both models is dependent on returns. It just happens that private equity groups have a longer time to prove themselves, have real control over their portfolio companies and can ride out most market storms.

Risks to Investors Investing in Companies that Run Private Equity Firms and Hedge Funds

Questions have been raised about the risks in investing in a Blackstone IPO, or equivalent, compared to other types of investments in equities. Investing in the Blackstone offering bears some resemblance to investing in a mutual fund management company. But there are some important differences.

Investors in Blackstone and in mutual fund companies are not buying the funds themselves. The Blackstone Group is trading on the returns and reputation of its managed funds, but what it sold was not a piece of any or all of those funds but rather a piece of the company (advising company) that manages that money. So the investor is not getting the risk or volatility (and returns) of the private equity investments but is investing in the fee part of the business. This fee business is generally stable given the longer term commitment of the investors in the private equity funds. This is similar to investing in any asset management company such as Janus, T.Rowe Price, Legg Mason etc. The private equity management firm can make even more money through the carried interest (the 20% profit share). So in a way, investing in the company that runs private equity funds exposes investors to risks that are not unlike the risks in investing in most other companies. The success of the company derives from the revenues generated. In the case of Blackstone and similar companies, the income consists of fee revenues for the funds, and the investor is not exposed to the risks of investing in the funds themselves. It is a business risk not unlike the business risk an investor incurs when he or she invests in any other type of company competing in the marketplace.

One major difference between a typical IPO and the Blackstone IPO is the way the Blackstone IPO was structured.

Investors have no say in how the company will be run. Since Blackstone Holdings was structured as a master limited partnership, investors are unit holders instead of shareholders. The difference is critical: Shareholders in a publicly held corporation vote to elect company directors, and a public company with shareholders must have a majority of independent directors on its board of directors. Unit holders, as in the case of Blackstone, lack those basic rights. They would not be entitled to vote to elect directors, and master limited partnerships are not required to have a majority of independent directors on the board of directors. The rules of the Blackstone Holdings master limited partnership even allow the directors of the company to sell the business without the consent of the unit holder. The directors also can pay themselves any salary they want since the firm is not required to have an independent compensation committee.

Personally, I am uncomfortable with the very limited rights of unit holders in this type of corporate structure. But it is legal and there are many other examples of companies where shareholders have limited rights as a result of two classes of stock. Many newspaper companies, for example, operate in this fashion in order for a minority of shareholders involved in the business to control corporate decisions. In the end, the investor is free to choose whether or not this arrangement is acceptable, and whether to invest in full knowledge of his or her limited say in the activities of the company.

Are Hedge Funds Safe for the Average Investor?

The biggest fallacy in the discussion about hedge funds is the tendency to paint them all with the same broad brush leading to the following conclusion: Hedge funds are risky investments. The truth is that there are dozens of different hedge fund strategies ranging from the very conservative to the very aggressive. We often hear about the very aggressive nature of hedge funds, particularly when something bad happens to one or more of them. I cover this subject in my forthcoming book, *"Build A Winning Portfolio*." (Kaplan, January 2008). The biggest problem with hedge funds is the lack of transparency. An investor seldom has any idea of what the hedge fund is doing on a day to day basis. The investor is informed of the general strategy, but there are typically enough loopholes in the agreement so that the hedge fund manager can do almost anything he or she chooses to do. In our firm, we strongly discourage investors from buying individual hedge funds. We do so to prevent the risk of a completely unforeseen disaster that no amount of due diligence could foresee. A perfect recent example is the debacle surrounding the demise of the Amaranth Advisors hedge fund. In 2006, a 32 year old energy trader at Amaranth made a huge bet on natural gas that resulted in a $5 billion loss in one week. The fund closed down shortly thereafter. The fund had bragged about its risk controls and other measures to prevent precisely the type of disaster to which it ultimately fell victim. Several prominent Wall Street firms had invested in the Amaranth fund for their clients through internally managed funds of funds. These firms all did the requisite due diligence to ensure that Amaranth's operations were up to par. Yet the disaster occurred.

The Role of Hedge Funds in Diversified Portfolios

While the instruments that hedge funds use might in isolation be risky, the *combination* of instruments in a hedge fund strategy can be rendered fairly safe. Moreover, in the context of the diversified strategies typically found in "funds of hedge funds", risk can be dialed up or down to virtually any desired level. Indeed, hedge funds of funds can be diversified enough and managed with sufficiently little leverage that a conservative fund of funds could be rendered as safe as short-term bonds, which are rather conservative investments. Lynx Investment Advisory, LLC manages a hedge fund of funds with just such a conservative approach – Lynx Partners, LP. Over the course of its five year history, this fund has exhibited less volatility than a standard portfolio of bonds. Of course, more aggressive funds could dial up the risk to pursue more adventurous strategies in pursuit of expectedly higher returns. The risk and return of such an

aggressive fund could be leveraged high enough to render it more risky than a portfolio of highly volatile micro-cap growth stocks.

Thus, hedge funds or, more to the point, hedge funds of funds can adopt strategies of varying risk. Before passing judgment on the efficacy of hedge funds for individual investors, however, it is also important to consider hedge funds in the context of more broadly diversified investment strategies. Hedge funds well may possess distinct characteristics that qualify them uniquely to mitigate the risks of standard types of investments in broadly diversified portfolios. Thus, any investor who holds an array of stocks, bonds, real estate and cash, or mutual funds covering these investment asset classes, could in principle benefit from the risk mitigation that hedge funds offer. And virtually every participant in a pension plan, owner of an IRA or similar investor does own such "plain vanilla" investments. Hedge funds behave very differently from stocks, bonds, real estate and cash – or in technical parlance, have returns that are weakly correlated with the returns on such standard investments. Therefore, including hedge funds as a minor portion of a larger, diversified portfolio can actually reduce the risk of the larger portfolio and increase its potential returns. In short, portfolios that include hedge funds can be more efficient than portfolios that exclude them.

Nonetheless, hedge funds are not for everyone. They are complex investment vehicles that use complex strategies that may be quite difficult to understand. No one should invest in such vehicles without either understanding them on their own or having a trusted advisor who can guide them through the thicket of myriad strategies and offerings available in the marketplace. Thus, it is appropriate and perhaps sufficient to limit these privately offered investments to so-called "accredited investors" who must meet certain income or asset tests or who have other qualifications for assessing the merits of these funds. Lynx Investment Advisory, LLC provides such guidance to dozens of its accredited clients who have chosen to partake of hedge funds as part of a more broadly diversified investment strategy. And thus Lynx serves as their guide through the thicket.

Investors with less experience, with lesser means and with no professional guidance now are prevented from investing in hedge funds. And this prohibition is appropriate. On the other hand, it is now possible to invest in mutual funds that have adopted many hedge-fund like strategies. In principle any small investor could invest in such mutual funds. However, regulations on mutual funds limit their latitude for borrowing, for leverage and for short-selling. Thus, the risk in these mutual funds is quite comparable to the risk of similar "plain vanilla" mutual funds that merely buy stocks and bonds in their portfolios without leverage, short sales or other hedge-fund tactics.

Should Private Equity firms and Hedge Funds be regulated by the SEC?

In my opinion, this debate boils down to the larger question of whether or not investors should be afforded some degree of oversight and protection by the appropriate regulatory authorities. In my opinion, the answer is: yes. Indeed, that was the purpose for the

creation of the SEC and subsequent legislation that followed. As a result, the American capital markets are the most respected and trusted in the world, largely because of the scrutiny and honesty that we impose on the process of offering and selling securities in this country.

My firm, like many others in our business, is registered with the SEC as an investment advisor. We are required to file annually, or in some cases more frequently, Form ADV with the SEC. This form requires us to disclose relevant information about our business including assets under management, ownership, directors, number and types of clients, among other things. We are subject to the rules of the Investment Advisers Act of 1940.

Now I have heard the various arguments about why hedge funds should not be regulated. Frankly, I don't get it. I am not an expert on securities law, but my simple analysis is this: If it looks like a duck, walks like a duck, and quacks like a duck, it is a duck. Hedge funds and private equity funds are investment offerings. Moreover, as a class, they are arguably riskier than other types of investment offerings such as stocks and bonds. As such, investors in these instruments should be entitled to the same degree of oversight and protection as are investors in other, and presumably safer, forms of securities.

In concluding, I would like to again thank the committee for allowing me to testify and I would also like to acknowledge the assistance I received from two of my colleagues at Lynx Investment Advisory LLC in the preparation of this testimony. They are Matthew D. Gelfand, Ph.D., CFA, CFP® and Vipin Sahijwani, CFA.