ITUC REPORT

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Where the house always wins: Private Equity, Hedge Funds and the new Casino Capitalism

ITUC CSI IGB

Founded on 1 November 2006, the International Trade Union Confederation (ITUC) represents 168 million workers, 40 percent of whom are women, in 153 countries and territories and has 304 national affiliates.

The ITUC is a confederation of national trade union centres, each of which links together the trade unions of that particular country. Membership is open to all democratic, independent and representative national trade union centres.

The ITUC's primary mission is the promotion and defence of workers' rights and interests, through international cooperation between trade unions, global campaigning and advocacy within the major global institutions. Its main areas of activity include trade union and human rights, the economy, society and the workplace, equality and non-discrimination as well as international solidarity. The ITUC adheres to the principles of trade union democracy and independence, as set out in its Constitution.

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Where the house always wins: Private Equity, Hedge Funds and the new Casino Capitalism

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This report draws on the experiences of private equity and hedge funds in the entire union family. We would especially like to thank the TUAC, the ETUC and the Global Union Federations for what they have done to highlight the challenges and problems of these phenomena, as well as to put them on the international agenda.

Where the house always wins: Private Equity, Hedge Funds and the new Casino Capitalism

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The Issues

> Don't believe the hype: private equity and hedge funds are largely overrated as investment opportunities. Some funds do have track records of very high returns – just as some mutual funds have – but overall, private equity has underperformed during the last decades while hedge funds have done so for the last couple of years or more.

> The present surge in leveraged buy-outs by private equity firms is part of a speculative craze that day by day lowers the standards and raises the prices for what is bought up. This is creating a bubble. Like all other speculative bubbles – from housing to stock markets – it will burst at some point.

> The debt leverage presently undertaken by private equity and hedge funds represents a great risk to the stability of financial markets. Many funds are so heavily loaded with debt that they risk defaulting if market conditions change. Due to their increasing size, this may start a domino effect with detrimental consequences for the major financial markets.

> Though fund managers will argue the opposite, the increasing dominance of private equity and hedge funds in the corporate world is undermining the long-term viability and competitiveness of individual companies and economies at large. These speculative models are inherently biased against any investment that does not pay off within a couple of years.

> Risks and rewards are extremely unevenly divided in the private equity model. Workers bear the brunt of risks, costs and sacrifices while managers of private equity firms pocket the gains. This constitutes a basic injustice – the cruellest kind of capitalism – and needs to be subject to rules and regulation so that the risks and the benefits are shared.

> The main winners of the private equity game are fund managers – not investors, employees, consumers or the public at large. Investing in private equity is indeed like playing the casino: sometimes you win big, other times you lose all. But the house always takes home the biggest bucks.

> Private equity firms are now milking companies and saddling them with debt to an extent that jeopardises the future of workplaces that employ hundreds of thousands of people.

> The management culture of private equity and activist hedge funds is shameless in its effort to cut all possible costs. It generally includes pressure on wages, benefits and working conditions; refusal to engage in collective bargaining; and outright harassment of workers who organise in trade unions.

> Tough regulation is necessary for both private equity and hedge funds. Codes of conduct and other voluntary arrangements are incapable of providing sufficient self-regulation. Only government action can curb the external impact and the outright exploitation of these investment activities. New, innovative regulation is seriously needed. This report explains how this can be done.

Where the house always wins: Private Equity, Hedge Funds and the new Casino Capitalism

Executive Summary

The phenomenon

Within the last couple of years, private equity and hedge funds have emerged as some of the most dominant financial and corporate players. They are no longer considered alternative investments but constitute part of the mainstream, one of the assets that pension funds, insurance companies and banks place their money in. They have made a lasting impact on the financial sector and have already made life harder for millions of ordinary workers while jeopardising their future pensions, as shown in this report. They are the epitome of the increasing financialisation of our economy, and the consequence is that their financial demands dictate the behaviour of ever greater parts of our society.

The boom in private equity and hedge funds has been triggered by a global abundance of cheap money, greedy investors and undervalued assets. The constant availability of credit with low interest rates has been instrumental in a surge in both leveraged (i.e. debt-financed) buy-outs and the gearing of hedge funds. As a result, the level of such buy-outs has set new yearly records for almost half a decade, while the level of assets under management by hedge funds has hit similar new records year after year.

When companies are taken over by these private funds, they escape stock market regulations, increase dividends to their new owners, and accumulate incredibly high levels of debt. Since the private equity firms aim at making quick returns by reselling their acquisitions within a couple of years, they introduce their portfolio of companies to rapid financial and organisational restructuring. Non-core assets are sold off and non-profitable operations closed. The workers in such companies under siege – typically, mature enterprises with a high cash-flow operating in stable industries – are the ones who pay the price.

The problems

The present wave of private equity-backed leveraged buy-outs, and money flooding into hedge funds, is neither benign, neutral nor insignificant. It has worsened a range of problems with regards to financial stability, transparency, corporate governance and economic development, while many of the fund managers at the centre of it have benefited immensely from the companies they have taken over. Concurrently, and as the bubble-like character of the boom has taken form, it is becoming clearer and clearer that it may come to a very sudden end. Yet as this eggshell economy of private equity and hedge funds is built increasingly on the money that should finance ordinary people's future pensions, and as ever more workers are employed by the companies owned by these funds, the fund managers stand to be those least hurt by such a crash. The rising levels of debt leverage used by private equity and hedge funds constitute the main threats to financial stability. Debt-to-equity and debt-to-earnings ratios are

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higher than anything ever seen in history, with the consequence that the level of risky credit commitments is disturbingly high. Regulators and supervisory bodies have already sounded the alarm and warned that financial crises and company bankruptcies are not far away. Individual company or fund problems, mass defaults of company bonds, higher real inflation or rising interest rates could all trigger them. Similarly, the risky fundamentals of private equity and activist hedge funds may also be a threat to long-term economic development at both the company and the national level. At the company level, this is because the short-term priorities of such owners are in conflict with the long-term investments in research, development and other factors that are necessary for ensuring innovation and competitiveness. At the national level, it is caused by both the effects of the individual company's priorities and by the financial impact the company and its owners have on the rest of society through taxation.

Pension funds are increasingly investing in private equity and hedge funds. There is a popular perception that they can make a higher return by doing so. But when the performance of these funds is taken as a whole and evaluated over a long period, their returns turn out be rather average and indeed they often under-perform. As such investments involve higher risks and greater fees, may weaken public stock markets, and may contribute to an intergenerational conflict between the interests of younger and older workers, pension funds need to be much more cautious about making them.

In their effort to make a return on their investment in the least possible time, private equity managers are always finding new ways of extracting more value rapidly from the companies they take over. While continuing their ownership of the companies, they frequently take up new loans to pay out dividends to themselves, sometimes the size of their original investment. And they engage in other dubious acts to cash in on their new ownership, like charging the companies they own large consultancy fees, or in other cases lending out money to their companies at interests well above market rates. At the same time, the buy-out managers often challenge competition laws by conspiring in so-called club deals and undertaking insider trading.

The effect on workers of private equity is also clear: it is basically a business model that is antagonistic to labour. With asset stripping, quick-flips and other ways of rapidly ensuring high returns as its main strategies, it has no interest in investing in its employees, no need for employer-employee partnerships, and no reason to provide anything but the minimum when it comes to wages, benefits and conditions. In its highly hazardous games of financial engineering which greatly increases the probability of bankruptcies, it is workers that bear the main risk. Leveraged buy-outs moreover change the character of industrial relations for many workers, leading them to face invisible employers that show no interest in dealing with their trade union representatives or informing them of what is happening to their workplaces. And they encounter cynical and harsh management practices that exploit them to the fullest as well as managers that openly admit to being hostile to trade unions.

But it is not just the workers in the companies that are taken over that suffer under private equity – so does society in general. The objects of leveraged buy-outs often end up reducing their tax payments substantially, sometimes even eliminating them, through the tax deductibility of the debt that has been used to acquire them. This essentially means that ordinary taxpayers cover considerable parts of the cost of the buy-outs, and even contribute to the riches that some people make on them. The quality of public services and utilities is furthermore imperilled when they are owned by private equity firms, because of the fundamental conflict between the long-term priorities that should guide public service providers and the short-term interests of the new owners. The private equity firm is spurred to reduce significant parts of the company's cash flow, which directly handicaps the service provider in its mission.

The levels of debt leverage and the prices paid for companies are rising day by day. Changes in financial or stock markets may cause today's deals to suddenly appear very expensive. This would put pressure on the returns of investments and make funds want to exit their exposed positions as soon as possible. The result would be extremely dangerous for the real economy. It is a sign of the mania that private equity buy-outs have turned into and of the continuously swelling bubble they are part of. It is clear that private equity and hedge funds today are risky businesses operating in an eggshell economy.

The solutions

Private equity and hedge funds operate in a policy and regulatory vacuum. Both the funds themselves and the companies they acquire are more-or-less 'hands off' for regulators and policy makers. But more direct policy making and regulation is exactly what is needed to handle the many problems that are the consequence of their emergence. Political action can and must regulate this industry, halt its excesses, and ensure that it only operates where it benefits average investors, workers and their societies. Private equity and hedge funds must play by the same rules as everybody else.

Such renewed regulation – as detailed in the last part of this report – must address transparency, financial stability, taxation, corporate governance and workers' rights, as well as the protection of public services and utilities. It must discourage quick-flips, uphold reporting requirements, limit the debt and leverage extravaganza, close tax loopholes and ensure that the private equity firms meet their obligations as employers.

The trustees and fiduciaries of pension funds must moreover consider investments in private equity and hedge funds very carefully. Due consideration should be given to the real profitability record of such investments, the risks associated with them, the many externalities they generate, and the direct or indirect impact they may have on the workplaces of the owners of the pension plans of tomorrow.

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I. Financialisation: today's face of capitalism

To put it in a nutshell, private equity funds have developed extreme forms of financialisation beyond the scrutiny of public stock markets, while hedge funds have invented new ways of speculating in everything related to the world of finance, day by day increasing the pace, volume and leverage of such speculation.

Since the start of the Industrial Revolution, the development of capitalism has been marked by different stages, each with their particular characteristics. Each stage has had its own predominant understanding of the company and of how to create growth and generate profits. Each stage has also had its set of dominant actors. Today's stage could be called one of 'financialisation', perhaps even 'late-financialisation'. Its protagonists are private equity and hedge funds.

Financialisation is not a word that appears in most dictionaries. But it is the best term to capture what is happening in our economies and their main private entities, companies. Financialisation denotes the growing dominance of the finance industry in the total sum of economic activity – a situation of financial markets determining the state of the overall economy, and of financial demands dictating company behaviour. It means that developments in interest rates and stock prices increasingly shape economic cycles and that financial concerns, and those who voice them, are ever more influential in setting corporate strategies. In short, it is the predominance of financial activities over production of goods and services.

Financialisation has become today's face of capitalism through changes in various parts of the economy. At the company level, it is linked to the 'shareholder value' approach to corporate governance, the model that gained momentum in the US and the UK from the 1980s on. It encourages financialisation of the company by maintaining that the purpose of its existence is to maximise the value of its shares rather than its long-term profits. Inherent to the logic of financialisation is that the company should be seen as a bundle of assets that generate different returns on investments, and that its purpose is to increase profits in the short-term by manipulating such assets through mergers, acquisitions and diversification. Financial ploys are used to increase the price of company shares. Other strategies particular to this corporate model are active use of debt, organisational restructuring and share buy-backs.

In relation to investment, financialisation is linked to deregulatory reforms of the investment chains, creating so-called dis-intermediation between owners of capital and the final destination of their investment. While once regulated and organised around private banks, insurance companies, cooperatives and public institutions, the investment chains of financial markets today function as a myriad of different types of institutions, transactions, services and products. Coupled with market liberalisation, this has allowed financial operators to operate in a vast investment universe, involving investment and trade not only in real assets, such as debt and equity, but also in market expectations and risks in the form of a plethora of derivative products such as so-called options, futures and swaps [1].

While financialisation has been growing for some time, it emerged fully in the 1990s. During the last couple of years though, it has entered a new sub-phase. This stage, which could be called late-financialisation, is driven by the explosion in private equity and hedge funds. To put it in a nutshell, private equity funds have developed extreme forms of financialisation beyond the scrutiny of public stock markets, while hedge funds have invented new ways of speculating in everything related to the world of finance, day by day increasing the pace, volume and leverage of such speculation.

Their increasing influence on markets and workplaces – shown by the fact that private equity is presently involved in between a quarter and a half of all major mergers and acquisitions in the US and the UK, while hedge funds account for 30-60 percent of daily global turnover in financial markets – has not gone unnoticed: they have changed the financial and corporate landscape as well as posing serious societal and economic challenges. And both types of investment funds have already made daily life harder for millions of ordinary workers while jeopardising their future pensions.

If past phenomena of capitalism are any guide, financialisation will soon be making its mark in the majority of emerging and developing countries, if it is not already there.

These protagonists of financialisation have so far had their most significant impact in North America and Europe, with most hedge funds operating from London and New York and the majority of private equity deals taking place in the US and UK. But the phenomenon is spreading quickly. New private equity and hedge funds are coming into existence all over the world and the long established players are extending their reach. Leveraged buy-outs in Denmark, Germany and the Netherlands are among the ten largest private equity deals ever in Europe. The Asia-Pacific region, with Australia as its hub, is seeing a wave of such takeovers. Leveraged buy-outs have taken place in Argentina, Brazil and Poland. Japan and South Korea have had their share of controversial deals, in South Africa major retailers have been bought up by funds, and in India a US$900 million takeover deal was struck in 2006 [2]. If past phenomena of capitalism are any guide, financialisation will soon be making its mark in the majority of emerging and developing countries, if it is not already there.

Private equity and hedge funds, as will be illustrated in the following section, have both similarities and differences. In this report, they are, first of all, dealt with jointly because they epitomise the present phase of financialisation, and because they are part of an intimate relationship whereby hedge funds directly finance a great part of the debt that private equity funds use to acquire companies, most often in the form of corporate bonds, and indirectly fuel the buy-outs by putting money into the leveraged loan market in their search for yields. And perhaps most significantly, they are scrutinized jointly in this report because they both pursue the kind of active, short-term strategies that are jeopardising good jobs and sound industrial relations, because they present the same kind of systemic risks to financial stability, because they both pose a possible threat to the future pensions of most workers, and because they represent the same regulatory concerns from corporate governance to taxation. However, as private equity funds have the largest impact on most of these concerns – particularly the ones related to workers and our societies at large – and as they are the most active player in the non-financial sphere, private equity is considered in greatest detail in this report.

The ABC of private equity and hedge funds

Private equity and hedge funds are both lightly regulated, private pools of capital. They manage money for the same kinds of investors – individuals, banks, insurance companies, endowments and pension funds – and have similar cost structures. Both kinds of funds aim at beating traditional investors, typically mutual funds, by not relying on normal market returns, but on generating returns independent of or, indeed, even contrary to the main market developments. And both kinds of funds use debt leverage, or 'gearing' as it is also called, to invest much more money than they actually have, aiming at taking home profits at a higher rate than the cost of credit, which at the same time evidently raises the risks of their activities. At the same time however, these funds vary in a range of ways. Investments through private equity funds are very illiquid in nature and investors are 'locked in' for a defined time, most often the entire term of the fund. Hedge funds, on the other hand, primarily invest in very liquid assets, with a much shorter time perspective, and generally permit investors to enter or leave the fund quite easily.

Private equity funds that finalised their fundraising in 2006 collected more than US$400 billion. In 2007 this figure is expected to rise to US$500 billion. The biggest private equity firms own businesses that employ hundreds of thousands of people and have combined annual revenues that would rank them within the first dozen of the Fortune 500.

Private Equity

Private equity, as such, is a broad term that refers to any type of equity investment in an asset in which the equity is not freely tradable on a public stock market. Passive investors put their money into private equity funds, which in turn are used by private equity firms for investment in target companies. Private equity investments range from leveraged buy-outs to venture capital for start-ups and other types of seed capital for more mature and established yet non-listed companies. However, the funds raised for buy-outs are nowadays by far the greater part, with around two thirds of all money going into private equity being designated for this kind of investment. By contrast, venture capital, which covers the kinds of investments that have entrepreneurship and job-creation at their core, only account for 5-10 percent of private equity investments at present [3].

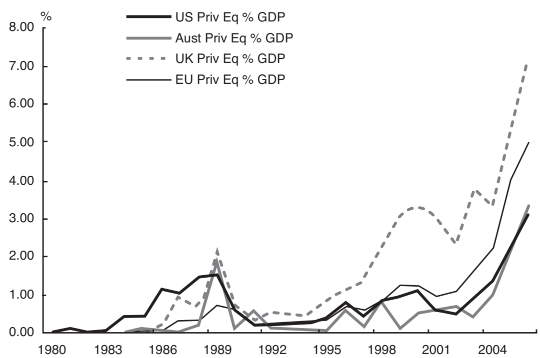
Private equity funds are the pools of capital invested by private equity firms. They are generally organised as limited partnerships that are controlled by the private equity firm, acting as a general partner. The fund gets the money that it invests from qualified investors such as pension funds, financial institutions and wealthy individuals. These investors become passive, limited partners in the fund. All investment decisions are made by the general partner, as the manager of the fund's portfolio of investments. The life of a fund is typically up to ten years, in which the limited partners have committed their capital and are unable to retrieve it. The fund will typically make a number of separate investments – generally between 15 and 25 – over its lifetime, with none of these investments being much above ten percent of the total commitments.

The general partners of the fund – in effect the private equity firms such as Bain Capital, Blackstone, Carlyle, KKR, Permira, Providence Equity and TPG, to name some of the largest and best-known – are usually compensated with a management fee and a performance fee. The management fee is defined as a percentage of the total investments in the fund, typically 2 percent but in some cases up to 4 percent. This fee is paid out to the general partners on a yearly basis. The performance fee, called 'carried interest', is based on the profits generated by the fund. The present standard rate is 20 percent. The performance fee is often only triggered when profits hit an agreed target rate of return, referred to as a 'hurdle rate'. This fee structure means that an investor, the limited partner, would typically pay US$20 to the general partners for investing US$100 in a fund with a ten year lifespan. And it means that the general partners would be able to retain US$40 after the ten years if the fund had generated US$200 on its investment. This would leave US$160 of return to the limited partner, in addition to recouping US$ 80 of their initial investment (US$ 100 – US$ 20). But it also means that if the fund came out with a loss of 20 percent the limited partner would be left with US$ 60, not US$ 80, because of the management fee.

Private equity funds receive a return on their investment in companies through one of the following ways: an initial public offering (IPO) on the stock market; a sale of the company they control, often to another fund; a merger; or through dividends paid out by recapitalisations. The latter, as will be illustrated later in this report, is most often nothing but a sophisticated way of milking companies. It happens when compantes borrow money in their own name, but rather than keeping this money in the company or using it for investments, they pay it out to shareholders. In general, private equity funds control the management of the companies in which they invest, frequently by bringing in new management teams that are closely linked to and take direct orders from the general partners. Private equity companies generally aim at, indeed promise, returns of above 20 percent per year. They often fail to meet these aims. But when they do, the lion's share of the returns can be attributed to the way the original capital has been leveraged through debt, as this enables the firms to make investments that are several times larger than the money their investors have committed to them.

Private equity funds that finalised their fund raising in 2006 collected more than US$400 billion. In 2007 this figure is expected to rise to US$500 billion, according to the consultancy Private Equity Intelligence [4]. Not even half-way through 2007, private equity has already been involved in blockbuster deals like the US$45 billion buy-out of TXU and the US$38 billion takeover of Equity Office Properties, the possible and much discussed US$22 billion bid for the British supermarket chain Sainsbury, the US$17 billion put down for the pharmacy Boots, and the US$11 billion bid for Qantas Airlines, which in the end did not go through. Household names like Burger King, Dunkin' Donuts, Hertz and Toys "R" Us are part of private equity portfolios and the biggest private equity firms keep on growing: Blackstone, for example, has now completed transactions worth US$200 billion. It owns businesses that employ more than 300,000 employees and have combined annual revenues that would rank it within the first dozen of the Fortune 500 [5].

Private equity deals in Australia, the EU, the US and the UK as share of GDP



Source: Thomson Financial

Hedge funds

Just like a private equity fund, a hedge fund is a lightly regulated private investment fund, which charges a performance fee for its services and which is open to only a limited number of investors. The term is not tightly defined but is used to distinguish such funds from retail investment funds, such as mutual funds that are available to the general public. Whereas retail funds tend to be highly regulated, limited to holding a specific range of financial assets such as bonds, equities or money market instruments and have a restricted ability to borrow, leverage or hedge their investments, hedge funds are limited only by the terms of the contracts governing the particular fund.

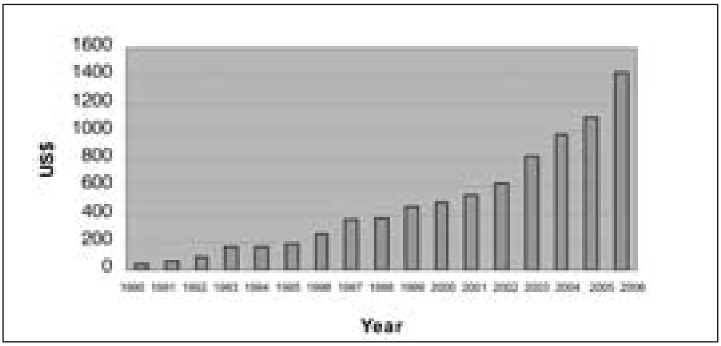
Hedge funds are a complex entity – indeed top regulators and financial watchdogs have often noted that they are perplexed by the reach of their activities – but should, besides their regulatory aspects, be differentiated from other funds by what they do. They most often use an active investment approach to play arbitrage opportunities that arise when mis-pricing of financial instruments emerges. They are also an extensive user of leverage as well as of sophisticated financial products such as derivatives [6]. They engage in different strategies relating to their exposure,

techniques, instruments and what market opportunities they pursue.
To put it as plainly as possible, hedge funds are basically investors that try to make a quick buck by speculating in everything possible. They do so without having to comply with the rules governing public funds, and with the ability to take on any kind of risk they so desire. Similar to private equity funds they are organised as limited partnerships and invest on behalf of wealthy individuals and institutions. Because of the substantial risks involved in their activities, they are normally only open to professional, institutional or otherwise accredited investors. Indeed, in the US hedge funds had been limited to individuals with a net worth of more than US$1 million, including the value of primary residences, since the 1980s. In 2007, however, this threshold was raised to US$2.5 million, excluding equity in any homes or businesses. Clearly, it is considered that this type of investment is so risky that only the super-rich should be allowed to gamble with their money in this game [7].

Lawmakers have limited hedge funds to institutional investors and wealthy individuals. In the US you now have to have a net worth of more than US$2.5 million, excluding equity in any homes or businesses, to invest in them. Clearly, it is considered that this type of investment is so risky that only the super-rich should be allowed to gamble with their money in this game

Hedge funds have grown quickly over the past 10 years. Globally, they have risen from a couple of thousand hedge funds then to almost ten thousand today. At the start of 2007, estimates suggest that hedge funds have assets of over US$1.4 trillion under their management. Indeed, some estimates have it closer to US$2 trillion. With general leverage levels of four to five – i.e. meaning that the funds can borrow money to a value of four to five times the value of the actual money they have raised, this means that hedge funds are active speculators with US$6 – 10 trillion at their disposal. Add to that the rapid and aggressive trading style that they employ, and their impact is even higher than the level of assets under their management would suggest. Depending on the financial instrument concerned, data from Greenwich Associates would suggest that hedge funds account for between 30 and 60 percent of financial market turnover. The bulk of hedge fund activity is in the US, the UK, the rest of Europe and Asia-Pacific, although for tax purposes, the majority of hedge funds – 64 percent in 2004 – are domiciled in offshore tax havens [8].

Total assets under management in hedge funds in billions



Source: Hedge Fund Research

Leveraged buy-outs: what, how and why?

Every day, a potential new deal in the present wave of leveraged buy-outs, undertaken by private equity firms and often partly debt-financed by hedge funds, seems to appear in the media. In 2006, the value of buy-outs in the US hit US$410 billion. And globally the private equity market completed deals worth a record US$730 billon, according to a financial consultancy company, Dealogic [9]. Nominally, a new record was set in early 2007, with the US$45 billion deal for the Texas utility company TXU – yet if judged by real value, the infamous 1989 acquisition of the food company RJR Nabisco by Kohlberg, Kravis, Roberts and Co. is still the biggest ever private equity deal. Every time a deal is made, billions flow from one place to another and millions are made by those that orchestrate them. And through a couple of signatures on dotted lines, hundreds of thousands of workers in effect have a new employer as well as a more insecure job future. But how and why do these deals happen? What companies and industries are being taken over? And why is this wave of leveraged buy-outs taking place right now?

The deals

The idea behind a buy-out is essentially to acquire a company at a low price, keep it for some time, and then get rid of it a higher price than was paid for it. In the present wave of leveraged buy-outs, private equity firms are particularly looking at publicly listed companies that in their view are either under-priced or under-performing. They believe that they can transform them so that they become more profitable and valuable, and then subsequently re-float them on the public markets, pass them on in a merger or sell them to another fund. However, the long-term profitability and value are not the main aim of the buy-out and the firm behind it: that is the returns that can be generated for the fund during the years that it holds the company. A company might therefore very well, as will be shown, become less profitable than when it was acquired, and be sold at a lower price, and still be a good investment for the fund and the firm behind it.

When deciding whether to acquire a company or not, private equity firms generally look at four different aspects: the present and potential capital structure of the company, the potential for operational change within the company, the existence of management incentives, and the exit options. The first aspect, capital structure, is the key feature of leveraged buy-outs. Indeed, the main point of the operation is to transfer risk to lenders and enhance the return on equity for the investors. A company may therefore be acquired by a fund using 20 percent equity, taken from the original investment in the fund by pension funds and the like, and 80 percent debt, delivered by banks and other credit markets. Depending on the legal jurisdictions where the deal takes place, the debt used to acquire the company is then either transferred to the company itself or placed in a holding company. For the acquired company it means that its debt levels rise sharply, often by more than 100 percent, and that from day one it will have to pay off this new debt.

The private equity managers – the general partners of the funds – take full control of the company once the deal is completed. Usually they quickly sell off non-core assets, sometimes to other entities that they own, and start a process of stringent cost-cutting. As they have to repay the debt quickly, the urgency of this is high. The company is restructured, very often including reductions in support functions as well as introduction of cheaper labour arrangements through laying off workers, pay cuts and the removal of benefits.

To attract or maintain what are considered to be good and efficient managers, so-called equity incentives worth between a half and one percent of the deal size are often introduced. That is why executives of companies taken over by private equity firms often receive tens of millions of dollars, euros or pounds as part of a deal. As will be shown later, this is far from benign. From the point of view of the new owners, stability is critical and management therefore often agrees not to leave the company before the investors have made their exit.

Once the right opportunity emerges, generally after three to four years but sometimes within just one year of the acquisition, the company will be passed on to new owners.

Any company that seems to be under-performing and able to carry twice as much debt as it presently does can end up as the object of a private equity raid.

This is often through an initial public offering (IPO) on the stock market. But unlike already listed companies, privately held companies can easily be re-listed in another country, where taxes may be lower, regulations fewer and the capital markets larger.

Leveraged buy-outs can dwarf ordinary returns on investments. Carlyle made a return of 128 per cent on their Hertz deal in less than one year; KKR earned more than 250 per cent on their investment in MTU Aero Engines in two years; Blackstone made 368 per cent in just seven months on a quick-flip of Celanese, a German chemical company; and Bain Capital has earned more than four times their initial investment in Burger King while still retaining a share of the now re-listed company[10].

Money is made in several ways on deals like this – though of course, the general partner has taken its first share, by means of the management fees paid by the private equity fund, even before the deal is made. As long as the profits of the company are higher than the money it has to use for servicing its debts, there will be a yearly profit which can be taken out as a return on the original equity invested. And if the company is resold at a higher price than it was bought for, then the whole premium can be pocketed by the private equity fund. Hence, by leveraging their equity these funds can, if all goes well, generate rates of return of several hundred percent in just a few years (though as shown in the next chapter, such high returns are the exception rather than the rule). Furthermore, the private equity companies have invented ways to pay themselves special management consultancy fees that often also run into the hundreds of millions. And as also shown later, they have become notorious for paying themselves huge, debt-financed dividends. This all adds up and means that successful private equity deals can dwarf ordinary returns on investments. The figures speak for themselves – companies have sometimes made profits of several hundred percent in a year or two.

The companies and industries

Private equity usually seeks out opportunities in mature industries with steady cash flows. In the most active markets this has primarily been consumer products such as beverages and foods as well as retail companies that also benefit from stable spending. The already mentioned buy-out of RJR Nabisco in 1989 and the present-day Boots and Sainsbury deals provide examples of this. Health care is also a popular sector for buy-outs as the US$32 billion buy-out of HCA, the largest private hospital chain in the US, in July 2006 illustrates. Public utilities have some of the same characteristics that guarantee income yet leave potential for expansion. Indeed, as mentioned above, in current dollars the largest buy-out as of mid 2007 was a utility company. Moreover, industries with monopolistic or oligopolistic markets – think car rental and especially Hertz – are also on the radar of the buy-out managers. In South-East Asia financial companies and banks have been popular, as well as the semi-conductor industry.

When it comes to the individual company, private equity firms generally go for targets that have under-geared balance sheets and space for taking on debt, so that the company can hold the leverage needed to finance both the takeover and recapitalisations for dividend pay-outs. Fund managers moreover look for poorly-performing companies that are cheaper than their peers, that seem easy to improve, or where there are possible synergy effects to be gained by matching them with companies already in the fund's portfolio. At the end of the day, any company that seems to be under-performing and able to carry twice as much debt as it presently does can end up as the object of a private equity raid.

Private equity has recently set its sights on state-owned companies, as they have many of the features of greatest interest to private equity managers. Generally, they are well-established enterprises with strong competitive positions, often in near-monopoly situations. Their debt levels are often low. And in the eyes of private equity, they are under-motivated entities with managers that are too soft and non-strategic. They are seen as sleeping giants with the potential for great cost-cutting and massive lay-offs, just waiting for a reinvigorating dose of management principles and corporate strategies. If governments and municipalities are ready to sell their public service providers, private equity firms are certainly among those most ready to invest.

Global private equity acquisitions of state-owned companies

Year	Number of deals	Value in US$
2000	17	1,515
2001	20	2,219
2002	14	1,976
2003	27	3,078
2004	30	10,269
2005	40	3,928
2006	46	14,324
Total	**194**	**37,309**

Source: Thomson Financial

The drivers

The present wave of leveraged buy-outs is driven by a number of factors, primarily cheap debt. This has opened up a massive opportunity for companies and investors to buy higher-yielding assets. Hedge funds base their existence on this and do so across a variety of assets. Private equity is taking up the same opportunity to use leverage to buy corporate assets on the stock markets, just to take the companies private. The availability of cheap debt stems from excess liquidity and savings in the global economy. With the increased significance of hedge funds and derivatives, and because the financial system today is as globally integrated as it gets, liquidity and financing is not a matter of national monetary policies. This means that though interest rates may be rising in some parts of the world, as they have in Europe and the US within the last year, the global price of credit can still be low. Indeed, financial experts assert that as long as the interest rates in Japan are close to zero and the exchange rate of the Chinese RMB is fixed, money will be more or less freely available to the main players of global finance markets.

While the fact that debt is cheap might be the main driver in leveraged buy-outs, it is not the only one. Corporate balance sheets and profits are also very strong at present – with the latter close to all-time highs in most of the OECD countries in the last couple of years – and hence attractive in the search for cash yields. Furthermore, fund managers and corporate executives are increasingly eager to take companies from public to private because by doing so they escape the growing number of reporting requirements and corporate governance regulations that followed in the wake of the Enron and WorldCom scandals. Hence, going private really means increasing the privacy of your business.

The advocates of the private market moreover argue that not being publicly listed enables executives to focus on the core business of their companies, because they no longer have to put out public reports, deal with shareholders, brokers and analysts nor worry about meeting margins on a quarterly basis. Besides regulation, leveraged buy-outs also enable big business to escape another of their most loathed duties: paying taxes. As will be shown in the next chapter of this report, private equity backed leveraged buy-outs significantly reduce the corporate income taxes paid by companies – indeed to the extent that some countries have already taken steps to discourage excess leverage. Finally, the fact that the so-called alternative investment class of private equity and hedge funds has become mainstream and surrounded by talk of above-average returns has increased investor interest in these funds and hence the capital available to them.

Bursting bubble, revamping regulation

The private equity and hedge fund-led phase of financialisation has already created enormous riches among a few – primarily the people managing these funds and the executives heading the companies they have taken over – and has made its mark on everything from corporate strategies and employment relations to public services and government revenues. Yet, though this leverage boom presently appears unstoppable, it may come to an end much earlier than expected. Its apparent strength and attraction may, indeed, ultimately become its weakness.

The flip side of all the deals, as will be shown in the next chapter, is that the funds are pushing the boundaries of what they do. Leverage levels and the prices that private equity firms are ready to pay for companies are rising day by day. The industry as a whole has too much money that it needs to put to work. In consequence, it is already making deals that it would not otherwise have made, taking on more debt than advisable, and raising the stakes for the assets it sets its eyes on. If stock markets keep on rising, their acquisition targets will naturally become more expensive and the attractively priced goodies will be fewer. The result will be lower returns to investors, bringing closer the day that the big buy-outs implode. Indeed, if global credit markets should change that day will come even quicker. And if the global economy at the same time weakens more than expected, it might all get very messy very quickly. Buy-outs would lose momentum and 2007 prices would seem exorbitantly high.

But before the bubble bursts by itself, it might also be popped by regulators. In what now appears as the early days of the leveraged buy-out boom, private equity and hedge funds were compared to a swarm of locusts. More recently, it has been remarked by some that is an insult to the locusts: the protagonists of financialisation are more like termites. They leave nothing behind to yield new crops but destroy everything on their way. Whether termites or locusts, such comparisons are a clear call for revamping regulation. That call will be echoed in the last chapter of this report. Before that though, the following chapter shows how private equity and hedge funds already raise a long list of concerns, how they entail a range of serious problems and how they challenge our societies and our workplaces.

II. Risky business: problems and challenges of private equity and hedge funds

The growing influence of private equity and hedge funds has not gone unnoticed. With good reason, concerns have been raised by a range of different actors – from financial regulators and governments to investors, community groups, workers and their unions. The concerns can be divided into two groups: one regarding the somewhat unintended externalities caused by these protagonists of financialisation; the other concerning the extent to which the model of leveraged buy-outs, in particular, is based on outright exploitation.

This report will argue that a very large number of problems and challenges arise from financialisation. It will focus on the most pressing challenges and problems in this chapter, out of the many that could have been included. Before turning to the perspectives of troubled tax collectors and worried workers, the chapter begins by assessing private equity and hedge funds by their own standards: their rates of return. Indeed, often when a problem is raised in relation to these funds and their activities, it is suggested that maybe it should be tolerated because of the high returns that they are able to generate. But do they actually deliver superior returns to investors?

Emperors without clothes

In the previous chapter it was noted that leveraged buy-outs sometimes deliver exorbitant returns to the private equity firms undertaking these operations – as shown, rates of return of several hundred percent have sometimes been realised in just a few years. But taken as a whole, the buy-out industry is much less profitable. Indeed, it seems to be no more than average. And interestingly, independent academic research has shown that the industry benchmarks that are often quoted when private equity managers boast about their performance seriously overstate the returns delivered by the funds. The industry counts the successful funds but omits the ones that failed to deliver returns or went broke before their completion. Hence, the buy-out kings might just be emperors without clothes.

A much-quoted study by academics from the University of Chicago and the Massachusetts Institute of Technology, which looked at the performance of private equity funds between 1980 and 2001, found that average fund returns, over and above fees, approximately equal the development of the 'Standard & Poor's 500', an index of large listed companies of which most are American. It concluded that the performance of fund managers varies considerably, and that while returns from venture capital may have slightly exceeded public market benchmarks, those of buy-out funds have slightly underperformed with regard to comparable public market indices. As the authors put it: "on average leveraged buy-out funds returns net of fees are lower than those of the S&P 500."[11]

In a similar study by the University of Amsterdam and the business school HEC in

"The large majority of buy-out funds fail to add sufficient value to overcome a grossly unreasonable fee structure."
DAVID SWENSEN, FUND MANAGER, THE YALE ENDOWMENT FUND, REGARDED AS ONE OF THE MOST SUCCESSFUL PRIVATE EQUITY INVESTORS

Pension funds today deliver around a quarter of all capital for private equity funds and are also raising their stakes in hedge funds. But many of them will look in vain for the returns they have dreamed of.

Paris, 1328 mature private equity funds were analysed. This study concluded that "performance estimates found in previous research and used as industry benchmarks are overstated."[12] Once again, spectacular private equity returns seemed to be more myth than reality. Indeed, the authors found that "accounting values reported by mature funds for non-exiting investments are substantial" and that there is a "bias towards better performing funds in these data. After correcting for sample bias and overstated accounting values, average fund performance changes from a slight over-performance to a substantial underperformance of 3% per year with respect to the S&P 500"[13].

Other studies confirm that when the particular risks of private equity – not least the high degree of leverage in buy-outs – are considered together with its other characteristics, private equity investments actually substantially under-perform the market on average[14]. Or as one of the most successful investors in private equity, David Swensen of the Yale Endowment Fund, has put it: "The large majority of buy-out funds fail to add sufficient value to overcome a grossly unreasonable fee structure."[15]

Compared to public equity and bond funds, it seems that there is a wide dispersion in returns across private equity funds, with a huge difference between the top and the bottom performers. This is also what the consulting firm Watson Wyatt concluded after studying the performance of private equity funds over the past 25 years: in short, the best private equity managers may well be able to generate well-above-average returns but there is no evidence that the asset class as a whole outperforms publicly-quoted shares.[16]

For those who have been in the investment and corporate restructuring business for a long time, there is really no magic about the buy-outs and the funds that perform them. Thus, a study by Citigroup argues that private equity is less about value creation and more about classic financial engineering. This argument is echoed by Jeffrey R. Immelt, Chairman and CEO of General Electric, in a comment on buy-out deals: "The vast majority only add value through financial rather than operational improvements."[17] The Citigroup study further shows that if pension funds and insurance firms had borrowed money themselves and invested it in a basket of companies in which private equity groups invested, they would have made higher returns than even the best-performing private equity firms[18].

Furthermore, and as warnings in relation to the current buy-out boom get increasingly prominent, it seems that the growth in fund size translates into a deterioration in investment returns. In other words the less money handled, the higher the profits; in private equity, a new book argues, size is the enemy of returns[19]. One has to wonder, therefore, what the returns on the mega buy-outs that we have seen of late will be.

For hedge funds the picture is much the same. When public equity markets are in a downturn, these funds tend to outperform them. This is because their strategy is based on making so-called 'alpha' returns that are not based on average market performance. But when the public markets are rising, hedge funds find it much more difficult to stand out. Hence, in the last four years investors would have been better off investing in the equity market in long-term positions than investing in hedge funds. Indeed, many hedge funds acknowledge themselves that they have underperformed.

It seems fair to suggest that a great many investors will look in vain for the returns they dreamed of when they first approached a so-called alternative investment fund. As long as these investors were the super-rich and corporations with booming profits that was less of a problem. But when they are the pension funds that are supposed to ensure that ordinary workers can live in their old age, it becomes critical. And that is increasingly the case. Pension funds on average deliver around a quarter of all capital for private equity funds and they are also raising their stakes in hedge funds. Yet, the lack of above-average returns is not the only thing that should worry pension funds.

Pension funds that believe in independence between managers and owners therefore should not invest in private equity and activist hedge funds.

Investor's gambles

The first consideration for evaluating the attractiveness of an investment service – which basically is what institutional investors buy when they put their money into private equity and hedge funds – is whether it is worth its price. The points above would suggest that private equity and hedge funds' performance is far from that. But there is more to it. These funds are not just delivering average performance, they also charge huge fees for doing so. This has already prompted one of the biggest pension funds in the world, the California Public Employees' Retirement System (CalPERS), to criticise hedge fund fees for becoming too steep. According to CalPERS, its US$4.3 billion hedge fund investments generated a return of 13.4 percent in 2006. That was slightly ahead of the average US hedge fund return of 13 percent but just below the 13.6 percent return of the S&P 500 that year[20]. Paying more for lower returns while at the same time taking on more risk makes sense for no one. The inherent problem, which will be touched upon again later, seems to be that at the moment the fee structures of private equity and hedge funds tend to favour themselves rather than their clients.

Private equity and hedge funds pose a risk to the financial stability of our economies and to long-term growth and productivity. That is bad news for most of us but worst for those worried about ensuring that their pensions make ends meet in 20, 30 and 50 years' time.

Investing in hedge funds and private equity may furthermore be against the interests and principles of pension funds because it can get them involved in setting individual company policies, hence taking them out of the sphere of making neutral investments. This is obviously the case for leveraged buy-outs but is also the reality when hedge funds take activist shareholder positions, which increasingly is the case. Pension funds that believe in independence between managers and owners therefore should not invest in private equity and activist hedge funds. Even without such principles, the strategies of making short-term returns at the expense of workers should cause pension funds to stay away from the agents of financialisation. To no surprise, this is exactly what the largest Dutch trade union, the FNV, has told its many trustees in a manual on pension investments[21].

"Institutions and their advisers are choosing to move into a form of investment that provides little real diversification from equities over time; comes with higher risks because of leverage; has far less transparency than a portfolio of listed stocks – for which the institution has to pay premium fees."
MICHAEL GORDON, CHIEF INVESTMENT OFFICER, FIDELITY INVESTMENT

Betting on private equity, in particular, may further be against the long-term interest of investors for a range of reasons. First of all, it shrinks the market that they usually deal in – that of publicly listed companies. In the first half of 2006 private equity firms in the UK raised £ 11.2 billion (US$22.4 billion) while ordinary corporations on the London Stock Exchange raised £ 10.4 billion (US$20.5 billion). Indeed, the private equity pressure is so strong that the Stock Exchange shrank by £ 46.9 billion (US$92 billion) over this period, despite a rise in average stock prices. This prompted the UK's Financial Services Authority (FSA) to warn that "the quality, size and depth of public markets may be damaged by the expansion of private equity. An increasing proportion of companies with growth potential are being taken private and fewer private companies are going public"[22]. The view is the same on the other side of the Atlantic. Here the losers of this development are furthermore identified: "Any shrinkage of the public equity market will leave the average investor in increasingly less liquid and more expensive markets than those enjoyed by institutions and the wealthy", said a report by a high-profile committee of experts backed by Treasury Secretary, Henry Paulson[23].

As indicated already, private equity and hedge funds are generally associated with higher levels of risks than most investments. These risks do not arise only from the

“The default of a large private equity backed company or a cluster of smaller private equity backed companies seems inevitable.”
FINANCIAL SERVICES AUTHORITY, UK

“The increasingly similar positioning of individual hedge funds within broad hedge fund investment strategies is another major risk for financial stability which warrants close monitoring despite the essential lack of any possible remedies.”
EUROPEAN CENTRAL BANK

activities of the fund managers; they are also linked to the general secrecy and non-transparency surrounding the industry. It suffers from a chronic lack of accountability, and that has serious implications for all stakeholders – not least investors. How, for example, can you make performance comparisons when you have no realistic indications of the performance of the industry? Moreover, the present private equity boom seems to be based on a leverage mania that has already created a bubble. That is a fact that investors ignore at their peril. Finally, and as will be further illustrated in this report, private equity and hedge funds also pose a risk to the financial stability of our economies and hence to long-term growth and productivity. That is bad news for most of us, and worst for those worried about ensuring that their pensions make ends meet in 20, 30 and 50 years’ time.

This prolonged ‘silly season’ of insurance companies, pension funds and others rushing to put money in leveraged buy-outs has been summed up very precisely by the Chief Investment Officer of the US-based financial services company Fidelity Investment, Michael Gordon: ‘institutions and their advisers are choosing to move into a form of investment that provides little real diversification from equities over time; comes with higher risks because of leverage; has far less transparency than a portfolio of listed stocks – for which the institution has to pay premium fees’. Silly, indeed, it seems.

‘Crash, boom, bang’ on the horizon

The continuously rising wave of leveraged buy-outs and speculative activities by hedge funds may come to a dramatic end sooner rather than later. As stated already, both phenomena are now so inflated that they appear to be bubbles. Lately, private equity firms have been able to increase their leverage from levels of five to six times their actual equity to as much as eight or nine times, greatly increasing the stakes and the returns needed to pay off the debt. Indeed, it seems that the smartest guys in the business have seen the writing on the wall – and, with Blackstone’s possible entry on the public market in mind, have started to get out before the party ends. While the private equity managers might be tight-fisted when cutting deals, they have been generous in sharing their warnings: William Conway, the founder of Carlyle, recently emphasised the “very risky credit decisions” being made at the moment in order to finance buy-out deals, warning that “the longer it lasts, the worse it will be when it ends.”[25] And already a year ago, Stephen Schwarzman of Blackstone pointed out that “when it ends, it always ends badly. One of the signs is when the dummies can get money and that’s where we are now”[26].

As money is cheap and private equity investment is in demand, general partners are bold and buy-outs are undertaken less and less cautiously. This raises the price of the companies that are taken over. Indeed, the FSA has calculated that the price-earnings ratio of UK deals to which banks committed capital rose from 11 times in 2005 to 14 times in 2006[27]. With higher prices for access to companies, private equity must either believe that they have the prospects of doing more managerial alchemy or that they can turn up their financial engineering a notch. In particular, the latter seems to be the choice in these days of vast amounts of low-priced capital. The consequence is not just that equity compared to debt takes up a smaller part of the deals, from 30-40 percent a couple of years ago to 10-20 percent today, but also that the difference between debt and the earnings needed to repay this debt is becoming bigger. Hence from 2001 to 2007, the average debt to earnings ratio of companies taken over rose from six to more than eight, according to Standard & Poor’s. And the indebtedness is often even more extreme. The broadcasting company Univision, for example, was taken private with a debt burden of more than 12 times its earnings[28].

History has shown that when leverage plays a role in strong market developments it often ends badly. And history may very well once again prove that it repeats itself.

It seems that the current private equity wave is driving up company valuations and so the amount of leverage required to finance the deals. In itself this increases the risk of individual defaults and bankruptcies. But it also creates more volatility in markets and poses widespread systemic risks and concerns. Excess liquidity might just be moving from market to market, first affecting real estate – where major corrections have already taken place, in the US for example – and then companies (or 'equities', as they are generally called in investment jargon). The cost of borrowing capital will eventually adjust upwards. When this happens asset prices will have to move down and most leveraged private equity players will be in trouble. Addressing both leverage and prices, the consulting firm Watson Wyatt has noted with some distress that "some prices have become totally disconnected from fundamental valuations (…) Private equity companies are taking on record levels of debt and easy credit has led to leverage structures that are incomprehensible. Any significant hiccup in the economy is likely to cause major problems for a few privately financed and over-leveraged companies. In the short term, returns will probably suffer a correction."[29] The International Monetary Fund (IMF) has similarly noted that "the increased use of leverage, which is readily available from debt markets today, may increase defaults among private equity/LBO transactions, with economic and macroprudential implications."[30] The FSA has further warned that the present use of leverage means that "the default of a large private equity backed company or a cluster of smaller private equity backed companies seems inevitable."[31] That again may lead to systemic trouble and complicated bail-outs by central banks.

Hedge funds pose their own set of risks both to their investors and to financial stability more generally. That became very evident when the American fund Long-Term Capital Management (LTCM) crashed in 1998. Its investors and creditors were only rescued by a bail-out from the US Federal Reserve. In 2006, the hedge fund Amaranth similarly went into liquidation. A pension fund of employees in San Diego reportedly lost US$105 million on this[32]. Since the LTCM crash, hedge funds have been under increased scrutiny. In 2006, the European Central Bank (ECB) issued a stark warning on their threats: "… the increasingly similar positioning of individual hedge funds within broad hedge fund investment strategies is another major risk for financial stability which warrants close monitoring despite the essential lack of any possible remedies. This risk is further magnified by evidence that broad hedge fund investment strategies have also become increasingly correlated, thereby further increasing the potential adverse effects of disorderly exits from crowded trades."[33]

In its Global Financial Stability Report released in April 2007, the IMF noted that "hedge funds may also contribute to increased or even extreme volatility in some instances" and highlighted "the potential impact that the failure of a hedge fund (or a group of funds) may have on major banks and brokers". The IMF further pointed out that "systemic risks regarding hedge fund activities primarily concern their potentially negative effects on systemically important regulated counterparties. Hedge funds may also act as transmitters or amplifiers of shocks initiated elsewhere." Finally, the Fund noted that "suggestions to require hedge funds to periodically disclose position information (e.g., to the public, investors, counterparties, and/or supervisors) have been met with strong resistance from the funds" but that "from a financial stability perspective, efforts to develop standardized leverage and liquidity measures for hedge fund disclosure (to investors and counterparties) could be useful."[34]

But hedge funds merit attention not only because of their investing strategies and their facilitation of other types of market behaviour. Like the private equity industry, they have also become significant users of debt leverage. And they are set to leverage their operations even more in the near future. Broking estimates suggest that for every 1 percent hedge funds pay out to their final investors, they need to

If the current leveraged buy-out boom continues, the world will see fewer innovative companies, able to start technological revolutions and enhance productivity as well as drive forward economies and create thousands of jobs.

generate almost 2 percent internal returns, because their investment strategies are based on making a very high level of transactions that all cost them varying fees and execution charges. So in order to make double digit returns to investors – who generally expect this as a minimum due to the high costs and risks involved in the undertakings – hedge funds will have to achieve internal rates of return at more than 20 percent. As many hedge funds invest in so-called spreads with relatively low returns, substantial leverage is needed to reach their targets. Furthermore, investors also expect hedge funds to out-perform the markets - if they did not do so, there would be no reason to invest in these funds. But for the last four years, as already noted, it is hedge funds that have been out-performed by the equity markets. So the pressure is on hedge funds to deliver. Owing to the nature of hedge fund activity, this means that they will probably leverage their investments even more than they are already doing. This will create systemic risks such as higher levels of defaults with losses to pension funds and other investors as a consequence. And, as with the leveraged buy-outs, it can create domino effects that spill over into other markets and influence employment prospects.

That private equity and hedge funds are taking advantage of the cheapness of credit in today's debt markets is evident. And that they are doing so at great risk is becoming clearer day by day. Indeed, the risk ratings that are attached to debt – to some extent expressing the expected likelihood of this debt being repaid – tell their own story. In 2006, more than 50 percent of the loans tied to highly leveraged transactions involved companies whose bonds or loan financing received a CCC rating, the lowest and most risky given to new financings, according to Edward Altman, professor at New York University. He warns that a third of CCC-rated bonds default within three years of issuance and that about 50 percent do so within five years. In his own words, "investors have been accepting spreads far too low for the risk involved."[35]

The real bottom line of the present leverage mania of private equity and hedge funds is the risk this poses to financial stability on one hand and to the sustainability of the real economy on the other. Financial crashes and company bankruptcies are not far away. They could be triggered by individual company or fund problems, mass defaults of company bonds, inflation or rising interest rates. Indeed, history has already shown that when leverage plays a role in strong market developments it often ends badly. If financial regulators fail to act on the risks, if strong credit assessments are not performed all around, and if companies fall short in stress-testing their leverage, history will once again prove that it repeats itself.

In it for the long run?

Just as the boom in private equity and hedge funds poses systemic risks to financial stability, the fundamental nature of private equity and activist hedge funds may also be a threat to long-term economic development at both the company and the national level. At the company level, this is linked to company-specific actions by management, new owners and activist minority shareholders. At the aggregate level of a nation or an economy, it is caused by both the effects of internal company priorities and by the financial impact the company and its owners have on the rest of society through taxation. Somewhat ironically, private equity firms argue that they should be considered long-term investors and moreover that by delisting the companies they take over, they actually free them from the short-term reporting requirements that public listings entail. Indeed, proponents of the private equity model tend to contend that it is more efficient than the publicly listed model precisely because it can change the focus from quarterly returns to three, four or five year returns. Any case of private equity being short-term is therefore met with the response that it is significantly more long-term than the mainstream of big business.

To eradicate poverty and to create the jobs needed for an increasing global labour force, the world is dependent on investments in education, research, technology and production. Yet, the overall rate of real investment in the world is falling – from 23.8 percent of GDP in the 1980s to 21 percent in the first four years of the new millennium. With the increasing dominance of private equity firms looking for quick returns and leveraged buy-outs with huge debt commitments, real investment might just fall behind even further.

However, while the present obligation of publicly listed companies to report quarterly earnings may be a burden and certainly often distracts them from ensuring the overall sustainability of their enterprise, there is good reason to think that private equity-owned companies and hedge funds that pursue an activist shareholder role indeed become biased towards short-term priorities. There are two broad reasons. First, the fact that the companies have to be turned around within a couple of years, and that the sole reason for their existence has been reduced to delivering returns to their owners, means that these factors will determine their strategies and actions. As the owners will be looking for a quick exit, managers will be under short-term operational pressure. And the practice of private equity-owned companies paying out dividends at much higher levels than other companies, often even exceeding earnings, means that these companies will have fewer resources to invest in the future. Secondly, the often doubled, tripled or further multiplied debt burden that companies end up with after leveraged buy-outs, means that all resources have to be mobilised to pay off this debt. It frequently means that they have to sell off otherwise productive assets or that they are simply left with trouble generating the revenues that are needed to repay this debt. Again, that can force them to ditch long-term strategic imperatives in order to serve their creditors.

As the current leveraged buy-out wave is still rising, and most companies have not yet been resold, the final verdict on whether they have continued to invest in their long-term future in the form of research, development and so on is still awaited. But the most plausible likelihood is that they have fallen far short. Since the fruits of R&D are often not reaped until up to ten years after their seeds have been sown, and given that outsiders will always be poorly positioned to judge the long-term innovation potential of an enterprise, there is not much reason for private equity-owned companies to keep high levels of expenditures on R&D, let alone expand them. This means that they undeniably will be less likely to invest in such activities. By not doing so, however, these companies may very well be less productive and competitive in the long-term – to the detriment of their employees, the local communities they are part of and the economies they contribute to. Nokia, for example, was originally a company that produced rubber boots and tyres. It also had a technology division, which later made the company the leading producer of mobile phones and the centrepiece of the turn-around of the Finnish economy that has for years put Finland on top of several rankings of countries' competitiveness. But for almost two decades, this technology division only made losses. That division would probably have ceased to exist if the company had been owned by a private equity firm. It is just as obvious that if the current leveraged buy-out boom continues, the world will see fewer innovative companies such as Nokia, able to start technological revolutions and enhance productivity as well as drive forward economies and create thousands of jobs.

Furthermore, the short-term behaviour of private equity-backed firms also creates spill-over effects among other companies. Companies that should be valued by their long-term performance are distracted from attending to the fundamentals of their businesses by the rationales that predominate among business and investors these days. "It is not easy to show vision and leadership with the overhanging threat of competition from, or takeovers by, private equity groups", an American CEO was quoted in the Financial Times as saying [36].

The lack of innovative R&D in the future will not only stem from shortcomings in company investment and risk-taking. It will happen just as much because governments will get lower corporate tax receipts and so have fewer resources to invest in the factors that enable such companies to emerge: education, research, technological development and state-of-the-art infrastructure. Indeed, judged by the effect private equity has already had on governments' tax revenues – sharply

When Warner Music was losing money on a daily basis, its new private equity owners made it take out a US$700 million loan out of which US$681 million was used to pay dividends to the shareholders and buy back a part of their stocks.

The value of dividend recapitalisations – the most direct form of value extraction – has increased more than tenfold in the time that the leveraged buy-out wave has risen. In a recent survey of large private equity firms, 97 percent of the respondents said that they expected to make dividend recaps in their portfolio companies in 2007, and 75 percent of them planned to augment their application of this form of value extraction.

reducing the corporate income tax paid by the companies bought up and minimising the tax bills paid by the general partners of the funds – public investment will have to be much lower in an era of financialisation and leveraged buy-outs. Unless, of course, someone else picks up the tab.

The fundamental issue about whether financialisation gives priority to short-term or long-term considerations is that both companies and nations increasingly depend on investments to stay competitive. The world as a whole is equally dependent on investments in education, research, technology and production to ensure development wherever it is lacking, to create the jobs that an increasing labour force will seek and to eradicate poverty. Yet, the overall rate of real investment in the world is falling – from 23.8 percent of GDP in the 1980s to 21 percent in the first four years of the new millennium [37]. With the increasing dominance of private equity firms looking for quick returns and leveraged buy-outs with huge debt commitments, real investment might just fall behind even further.

Milking, milking and milking

Investments by private equity firms are about achieving as high returns as possible as fast as possible. The exit of a company – its resale, merger or public re-listing – is viewed as the main way of doing so. But private equity managers are becoming more and more sophisticated and cynical in their ways of extracting values from the companies they take over. They increasingly find means to pay out dividends the size of their original investment while still owning the company. And they are ever more often seen engaging in other dubious acts to cash in on their new ownership, like charging the companies they own large consultancy fees and lending their companies money at well above market rates.

So-called dividend recapitalisations or 'recaps' are still the favoured way of milking companies. They are performed by having the acquired company take on new debt, which is then used to pay out special dividends to the owners. This means that the dividend, in contrast to typical practice, comes from debt instead of earnings. And it means that the debt is used for rewards to the owners rather than investment – again, in stark contrast to sound corporate behaviour and grossly exploiting the favoured tax treatment that corporate debt receives, precisely because it is meant to be used to enhance investments.

The list of cases where private equity firms have cashed in on their investments very early through dividend recaps is long. And the numbers are staggering. In late 2004, when Warner Music was losing money on a daily basis, its new private equity owners made it take out a US$700 million loan out of which US$681 million was used to pay dividends to the shareholders and buy back a part of their stocks [38]. And Intelsat, once a government-owned company facilitating TV images through satellites, took on new debt in 2005 to pay out US$548.8 million in special dividends to the consortium of private equity firms that had acquired it with the use of US$515 million of their own money a couple of years earlier [39].

Very often such dividend recaps cripple the companies with debt to an extent that forces them to fire many of their workers or simply makes them go broke. In 2000, for example, Bain Capital purchased the American company KB Toys in a US$300 million deal through an equity investment of only US$18.1 million. Less than a year and a half later, a dividend recap was used to pay the owners and several KB Toys executives US$120 million. Not long after that, the company filed for bankruptcy protection and nearly a third of its employees lost their jobs [40]. One would think that such value extraction and asset stripping of companies that then go bankrupt would be illegal. But in most countries it is apparently fully legal.

The value of such dividend recapitalisations has increased more than tenfold in the time that the leveraged buy-out wave has risen. In 2002, their volume was US$3.9 billion, according to Standard and Poor's. In 2005, it was US$40.5 billion. For the first half of 2006, the use of such recaps was reportedly up another 23 percent compared to the same period in 2005. And in a recent survey of large private equity firms, 97 percent of the respondents said that they expected to make dividend recaps in their portfolio companies in 2007 while 75 percent planned to augment their application of this form of value extraction [41].

"How will private-equity firms continue to make money by just flipping and flipping and flipping? They'll make it on fees, fees, fees."
WARREN BUFFET, FOUNDER, BERKSHIRE HATHAWAY

Other milking techniques, as mentioned above, include management and consultancy fees as well as shareholder loans. As the private equity firms that take over the companies not only often appoint new management but also often have their own employees work on the restructuring and financial engineering of these companies, they have found it natural to charge the companies large sums for such work. Hence, after Blackstone had acquired Celanese, a German chemical company, they charged it US$64 million in 2004 for their advisory services, followed by US $ 45 million in 2005 [42]. With regard to shareholder loans, an investigation by the Danish tax authorities found that Danish companies that had been taken over by foreign private equity firms took up loans from their new owners at rates that were twice as high as normal bank loans [43]. They furthermore discovered that the large sums that were paid out in dividends to the private equity firms were often returned to the companies as loans. The latter trick is attractive because of the tax deductibility of the interests paid on such debt. In the end, it too adds to filling the pockets of the fat cats of private equity – this time at the expense of ordinary taxpayers.

Club-deals, insider trading, management disloyalty and other moral hazards

While the milking of companies outlined above might not fall under criminal law in most countries, it is certainly close to that. And there is good reason to be concerned about the way that the buy-out groups are able to exploit debt markets, and the companies they win ownership over, to reward themselves. So while these practices are often legal, they, and a range of other aspects of private equity that will be covered in the following sections, do indeed relate to corporate governance and prudential rules as well as other hard and soft regulations for running businesses and operating in financial markets.

A range of the largest American private equity firms – including Carlyle and KKR – are under investigation by the US Justice Department for their participation in 'club deals'. Such deals arise when firms come together to make joint bids and buy-outs. As deals have been getting bigger, the practice of making club deals has become more frequent. Most private equity firms, in spite of the growing size of the funds they manage, are still unable to perform the largest deals alone. Out of the ten largest deals in the US in recent years, eight have been club deals involving several players. The value of these deals reportedly totalled more than US$270 billion and covered 630,000 employees [44]. Club deals, however, have not come under scrutiny because of their size or the number of jobs that they put at risk. Rather, it is because they are seen as reducing the competition for a company and hence the price paid for it. Indeed, the Justice Department investigation into these companies concerns whether they have formed their bidding groups in order not to compete against each other and so hold auction prices down [45].

Another serious issue related to private equity firms is whether their deal-making creates abuse of information. Such abuse, otherwise known as insider trading, can be performed by both the firms pondering whether or not to bid as well as by other market actors investing in shares and other products. The UK's Financial Services

Authority ranked market abuse as the highest, most significant and widespread risk associated with private equity in its 2006 assessment of this subject. It noted that "the significant flow of price sensitive information in relation to private equity transactions creates considerable potential for market abuse. This flow is increasing as the complexity of the transactions grows and more parties become involved. The involvement of participants in both public and private markets and the development of related products traded in different markets, e.g. CDS (Credit Default Swaps) on leveraged loans, increases the potential for abuse. (…) we have identified the biggest risk as the potential for the leakage of information. This risk exists because of the large number of individuals involved in private equity deals and because not all participants will be successful in their proposed participation."[46]

Similarly, and intimately linked to the question of who holds what information, the issue of management loyalty has been raised in several private equity deals. The issue arises because the executives, who are supposed to serve the present owners of the companies they work for, often have personal interests in a takeover or a leveraged buy-out. Such problems of loyalty occur when the management is offered a huge personal bonus to be paid once the deal is closed or, as is also seen, when they are included in the group of investors buying the company. It does not seem farfetched to speculate that this is done to neutralise any possible opposition to a takeover from the target company's top executives. Indeed, some governments have already highlighted this possible conflict of interest between executives and the shareholders whose interests they are obliged to look after, and proposed ways of overcoming it – for example by banning agreements on stay-on bonuses between executives and bidders before any deal is closed[47].

More generally, it seems that the boards of directors of companies become increasingly irrelevant when they are taken over by private equity firms. This goes against all traditional assumptions of good corporate governance, which are based on the premise of an active and independent board. The division of roles between shareholders and management – the owners of capital and its employers – is furthermore fictional when owners are private equity firms. Such firms are in a position to gain considerable influence over company management, but without having to face the requirements of accountability that are in place for public listed companies.

Within private equity funds themselves – and hence between general partners and limited partners, i.e. the managers of the money invested and the investors – another set of conflicts and moral hazards also exist. These regard the fee structure and the allocation of risk, which both fundamentally favour the general partners. As shown in the first chapter of this report, a fund manager loses nothing from a failing fund and will often have an interest in taking a loss in a position as quickly as possible if it appears to be non-profitable. Or as Warren Buffet, the founder of Berkshire Hathaway and probably the most successful investor ever, has said: "How will private-equity firms continue to make money by just flipping and flipping and flipping? They'll make it on fees, fees, fees."[48]

Bearing the brunt of risks and cuts – workers under private equity

One of the most contested aspects of private equity is its impact on jobs. Whenever workers and their unions tell of how companies taken over by private equity firms cut jobs, put pressure on wages, remove benefits and impair working conditions, the private equity lobby is quick in responding that overall its members create employment and do so at a faster rate than other firms. But even if that were true, aggregate employment creation says nothing about the quality of jobs and employment relations or about developments in remuneration and working conditions.

At the national and international level, the facts regarding private equity's quantitative effect on jobs are so far limited. Most studies on the issue, furthermore, have methodological problems and are far from independent. When the studies are commissioned by the private equity lobby itself, the results seem predisposed to find results that reflect well on private equity. As they often fail to distinguish between venture capital for start-ups and money that goes into buy-outs, or they mix 'organic', real employment growth with that of mergers and acquisitions, their numbers do not respond to what the issue is all about: whether private equity-backed buy-outs create new jobs or reduce them. One detailed analysis of 1,350 buy-outs in the UK between 1999 and 2004 found that the answer could be both 'yes' and 'no'. On average, all the companies cut jobs in the first year after the takeover. In the longer run, however, around two thirds of them added jobs throughout the time that they were privately held, while around one third of them cut jobs in that period. The job cuts were the most severe – reducing the workforce by 18 percent over the six year period – in companies where the new owners brought new management with them. In companies where the management stayed the same, the workforce grew by 36 percent between 1999 and 2004 [49].

Private equity backed companies generally embark on tight cost-cutting strategies once they have been taken over. The impact is felt by the workers who have to do more for less.

In their effort to extract value from companies and ensure that they can get a higher price for them than they paid, private equity managers can basically do one of two things: sell off non-core assets and reduce activities, which would mean cutting staff, or increase cash-flow by expanding activities, and consequently taking on new employees. So the fact that some private equity owned companies can show employment growth should come as no surprise. Neither should the statistics presented by the industry groups. First, such statistics include all capital held by private equity firms, including venture capital. Secondly, private equity firms – diligent in analysing the perspectives for profit-making as one would expect – naturally only invest in companies they believe they can make more valuable.

However, private equity-backed companies generally embark on tight cost-cutting strategies once they have been taken over. The impact is felt by the workers who have to do more for less. As the buy-out groups target companies they believe they can make leaner and fitter – where they see a potential for cost-cutting, optimising and organisational restructuring – reducing employment costs in such companies is a predictable outcome. The fact that the companies have to pay off debt quickly only adds to the urgency of squeezing the workers who remain on the payroll. Indeed, the study of 1,350 buy-outs referenced above found that the wages of the workers in these companies grew at a slower rate than wages in other companies. On average, a worker in one of these companies had a relative loss of £ 83.70 (US$167) a year compared to similar firms with traditional ownership. Where the new owners installed new management, the relative loss per worker was £ 231.35 (US$460) a year. The study also found that the bigger the firm taken over by private equity, the greater the downward pressure on wages [50]. Individual workers and their unions can tell of yet more stringent job and wage cuts.

Downward pressure on wages, conditions, pensions and other benefits

> Soon after the UK's Automobile Association was taken over by CVC and Permira in 2004, the company reduced its workforce from more than 10,000 to 7,000. Today, the AA is severely under-staffed and workers are forced to take on extra shifts as well as forfeit or postpone their annual leave [51].

> Eircom, the largest Irish telecommunications provider which was taken private in a

club deal in 2005, is reported to have slashed all investment in training after the takeover.

> In Germany, the bathroom and kitchen producer, Grohe, was re-sold to new private equity owners in 2004. Soon afterwards, it announced that half of its jobs in Germany would be cut. At the end of the restructuring, and after the local union had put forward serious alternatives, the cuts were less severe yet still totalled 770 [52].

> After Intelsat had been acquired by a consortium of private equity firms in 2001, labour costs were quickly slashed. Between June 2004 and September 2005 alone, the workforce was reduced by 18 percent. The company moreover refused to honour retiree medical benefits, claiming that they were not obligated to fulfil promises made by the previous owners. The company was subsequently taken to court and is presently giving major concessions in a settlement with the retirees [53].

> Gate Gourmet, which was taken over by TPG, has seen its workforce decline from 26,000 to 22,000. Its permanent staff works under the threat of being made redundant and temporary workers are frequently engaged. Workers on sick leave and holiday have often been sacked by letter only [54].

> Less than an hour after acquiring Airwave, the company that provides the digital radio network for UK emergency services, in a £ 2 billion (US$4 billion) deal, the new private equity owners announced that they were scrapping the existing, guaranteed benefits pension scheme [55].

The cost-cutting of private equity firms is not limited to the companies it takes place in. It spills over into publicly listed companies and hence creates waves of layoffs and wage-pressure outside the private realm. Hence, these days it is not uncommon to see companies eliminating jobs as well as taking on additional debt, just to hold off private equity bids. Often though, the buy-out groups still catch them and then more cost-cutting, including layoffs, is on the agenda.

Whether an individual company that has been taken over in a buy-out creates or cuts employment, whether it allows normal wage developments or squeezes them, whether it invests in its workforce or exploits it as much as it can, private equity is fundamentally a worker-hostile business model. With asset stripping, quick-flips and other ways of rapidly ensuring high returns as its main strategies, it has no interest in investing in its employees, no need for employer-employee partnerships, and no reason to provide anything but the minimum with regards to wages, benefits and conditions. In its highly hazardous games of financial engineering, which greatly increase the probability of bankruptcies, it is workers that bear the main risk. When private equity-backed companies crash, their owners will almost always have recouped at least their initial investments by having taken what they could of the companies' revenues before the collapse. Workers, on the other hand, stand to lose their job, their income and any pension and healthcare plan that may have come with it. Paul Myners, a former chairman of Marks and Spencer, captured the risk-and-reward relations of the private equity model very well when he said: "The one party that is not rewarded is the employees, who, generally speaking, suffer an erosion of job security and a loss of benefits."[56]

Invisible employers, lack of information, no consultation – industrial relations under private equity

Today, almost 20 percent of those working in the UK's private sector are estimated to be indirectly employed by private equity firms. In France, it is around 9 percent and in Denmark 4 percent. In effect, the largest private equity funds have emerged as the de facto employers of hundreds of thousands of workers, placing them among the world's largest employers but without them acknowledging any employer

"The one party that is not rewarded is the employees, who, generally speaking, suffer an erosion of job security and a loss of benefits."
PAUL MYNERS, FORMER CHAIRMAN OF MARKS AND SPENCER

When companies are taken over by private equity firms, their workers are generally sidelined without any information or influence on the deal. Their new employers are invisible to them and though the deal may change their working life, they are left in uncertainty about their future.

responsibilities. Bain Capital owns companies that employ 662,000 people, KKR's portfolio companies have 540,000 people on the payroll, for Blackstone the figure is 350,000, for TPG it is 300,000 and for Carlyle it is 200,000 [57]. Private equity is indeed changing the face of industrial relations for many workers – unfortunately in ways that cause a deterioration in traditions of social dialogue that it has taken decades to establish. On the one hand, workers face invisible employers that show no interest in dealing with them or informing them of what is happening to their workplaces. On the other, they encounter increasingly cynical and harsh management practices that exploit them to the fullest as well as managers that openly admit to being hostile to trade unions.

When companies are taken over by private equity firms, their workers are generally sidelined without any information or influence on the deal. Their new employers are invisible to them and though the deal may change their working life, they are left in uncertainty about their future. This is basically against the principles behind the rules that govern transfers of ownership in most countries. In the EU, for example, the Acquired Rights Directive [58] is intended to ensure continuity of employment terms and conditions in the event of a takeover. The Directive and national regulation, such as the UK's 2006 Transfer of Undertakings (Protection of Employment) Regulations (also know as TUPE), require prior disclosure of relevant information to employee representatives, prior consultation with employee representatives, and protection of the individual employees affected. But such rules do not apply in the event of a wholesale transfer of share ownership. This means that private equity buy-outs are not treated as a change in ownership affecting industrial relations. And it means that private equity firms can evade any employer responsibility in a collective bargaining process. As pointed out by the International Union of Food Workers (IUF), a global union federation, some of the world's largest de facto employers "now inhabit a parallel universe where many of the key aspects of industrial legislation do not apply." [59]

Furthermore, workers and their representatives are often met with corporate bullying and grand-scale union-busting after being taken over by private equity firms. The working environment and the relations between employees and managers have deteriorated in many companies following buy-outs. Sometimes, particularly when the new owners have demanded substantial layoffs, managers are reported to have engaged in harassing the most vulnerable workers in their workplaces. The Automobile Association is, according to the UK's GMB trade union, a case in point. While the experiences from individual cases are grim, academic research shows that such experiences are not isolated but rooted in general management approaches to unions. Hence, a study of buy-outs in the Netherlands and the UK found that the number of companies recognising unions fell after such takeovers. It moreover showed that only 6 percent of Dutch managers and 10 percent of UK managers in the sample of private equity-backed companies had a positive attitude towards unions, and that 40 percent of the managers in the private equity-backed companies in the UK had a negative stance on unions [60]. The Work Foundation, an independent London-based think tank, takes these findings to "imply that derecognition [of unions] was at the very least one motive for going down the private equity route." [61]

Aggressive tax planning at the heart of the model

As has been shown in previous parts of this report, the transition of private equity from an alternative to the more mainstream investment class has been triggered by low interest rates and excessive use of debt leverage. Intimately linked to this is the tax treatment of debt and the fact that many companies that have undergone leveraged buy-outs have reduced their tax payments substantially. This means that a great part of the extra costs of taking on additional debt is covered by such tax deductions.

Scrutinizing the records of seven large companies that had been taken over by private equity firms, the Danish Ministry of Taxation found that they reduced their tax payments by more than 85 percent after the takeovers. It estimated that it is presently losing around DKK 2 billion a year in public revenue because of the aggressive tax planning of private equity firms, and that if it refrains from acting, these losses will rise to DKK 15 billion a year – equal to 25 percent of the total income from corporate taxation – in a couple of years.

"It is not hard to create jobs and create growth, if the company taken over by an equity fund doesn't pay tax, while its competitors do. That doesn't impress me."
KRISTIAN JENSEN, MINISTER OF TAXATION, DENMARK

Interests paid on debt are tax deductible in most jurisdictions because they are seen as a business expense that allows the enterprise in question to operate, hire people and invest in the future. In leveraged buy-outs, however, debt is used for the sole purpose of acquiring a company – that is, the transfer of ownership and not the creation of any economic value, production or employment. This is possible because in most countries it is possible to establish joint taxation or tax consolidation between a holding company and the company it acquires in a buy-out. The consequence is that a company can in effect be bought with its own money, that company taxation is severely reduced (particularly in cases where the debt financing comes from abroad and the new owners are based outside the acquired company's country of residence) and that countries' tax bases are eroded.

While there is much anecdotal evidence of the aggressive tax planning of companies that have been taken over by private equity firms, there is so far a lack of studies documenting the macroeconomic effects. However, an ongoing investigation by the Danish Ministry of Taxation shows the alarming effect that leveraged buy-outs can have on public finances. Scrutinizing the records of seven large companies that had been taken over by private equity firms, the ministry found that they reduced their tax payments by more than 85 percent after the takeovers. In the year of the buy-out they collectively paid DKK 2.4 billion (US$420 million) in corporate income tax. In the first year after the buy-out, this was reduced to DKK 400 million (US$70 million). It further found that at least one of the companies would have a tax refund because of the increased debt interests that it was now servicing [62].

Before releasing these results, the Danish Government had already estimated that it was losing crucial tax revenue due to the tax avoidance of foreign private equity firms. Hence, in the early part of 2007 it said that its analyses showed that "a range of private equity funds are carrying out tax planning with an aggression beyond what has so far been experienced, and in reality do not pay Danish company income tax." [63] And it stated that it would have none of it. The Government estimated that it was presently losing around DKK 2 billion (US$350 million) a year in public revenue and that if it refrained from acting, these losses would rise to DKK 15 billion (US$2.6 billion) a year – equal to 25 percent of the total income from corporate taxation – in a couple of years. In January 2007, the Government – one that is made up of conservative and liberal parties, and in general is considered to be very business friendly – therefore proposed legislation to curb private equity's abuse of Danish tax rules. And in April 2007, it announced that it had reached agreement with its coalition partner about amendments to the existing legislation in this area [64]. The new legislation may be adopted already in the summer of 2007. It will mean that the debt deductibility of interests is limited to companies of a given size – in practice only the 1,000 largest companies in the country – in a way that hurts only the most aggressive tax planning companies. The Government believes that with this legislation it will hit the buy-out groups in the heart of their operations and that they will therefore look to other countries in the future. Addressing a group of national and international private equity funds who argued that they were creating jobs in the country, the Minster for Taxation, Kristian Jensen, replied sharply: "It is not hard to create jobs and create growth, if the company taken over by an equity fund doesn't pay tax, while its competitors do. That doesn't impress me". He went on to say that "the more aggressive tax planning pushes our legal boundaries, the greater the pressure will be on politicians to act and to stop it through ever more detailed legislation."[65]

The German Government has also noted the problem of diminishing corporate tax revenues and has started the preparation of similar legislation to tighten the law regarding deductibility of debt. The proposal underway in this country is said to be even stricter than the Danish one, capping the interests that can be subtracted from earnings at a much lower level. In the UK, the authorities are looking into this area. Hence, in March 2007, the Economic Secretary to the Treasury, Ed Balls, said that the present taxation of private equity firms was "giving these arrangements a tax advantage that is inconsistent with the principle that interest is a business expense", and announced "that the Government will review the current rules that apply to the use of shareholder debt where it replaces the equity element in highly leveraged deals in the light of market developments, to ensure that existing rules are working as intended."[66] Similar investigations and reviews have been announced in other countries where private equity has been on a shopping spree, including Australia.[67]

Similar to the issue of corporate taxation of private equity owned companies is the tax treatment of managers of private equity and hedge funds. As mentioned in the first chapter of this report, these managers have a major part of their earnings – the standard 20 percent 'carried interest' they charge on returns above certain thresholds – taxed at the low capital gains rate, not the higher income rate. In the US, this means that they get away with paying 15 percent tax instead of 35 percent. In the UK it has been reported that managers get away with paying just four to five percent tax on income that runs into millions.[68]

Legal experts are increasingly concerned by the inequities and anomalies of this situation. Victor Fleischer, associate professor at the University of Colorado Law School, notes that "private equity fund managers are managing the fund and putting up only small amounts of capital themselves and yet the returns from their labour income are treated as capital gains. So that's an anomaly in the tax system. When you perform services you normally get taxed at ordinary income rates, and so we have some of the very richest laborers in our country being taxed at a low tax rate."[69] Regulators have also started looking into this subject. Hence, the US Assistant Treasury Secretary for Tax Policy, Eric Solomon, has confirmed that both the Treasury and the IRS are looking into the tax treatment of hedge funds, and US Congressional tax committees are doing the same with regards to private equity managers.[70]

Public services and utilities at peril

In the first chapter of this report it was pointed out that private equity firms have increasingly set their sights on state-owned companies and other providers of public services and utilities. During the last ten to twenty years, large numbers of such companies have been fully or partly privatised. They often still operate in somewhat monopolised markets that require regulation to keep monopoly power in check and to ensure that service commitments are maintained. However, the transfer of ownership of such companies to private equity firms, whether this happens as a first privatisation or is a second or third sale after privatisation, creates a series of conflicts and possible problems for the societies these companies are meant to serve.

First of all, there is a clash between the stated long-term priorities of the service providers and the short-term interests of the new owners. The private equity firm, as in the case of other types of companies it takes over, will be motivated to take out significant parts of the company's revenues in order to reward its investors and to pay off the debt that it has used to acquire it. Under other circumstances such revenues could have been used to finance re-investments, to lower prices or to improve the quality of the services delivered. As the company is also likely to take on further debt, in the future it will generate fewer funds for further investment and so receive a lower credit rating, making any loans it needs for expanding operations more expensive. In consequence, and as the logic of the new owners would also dictate, increases in prices paid by consumers are likely to occur.

Regulation must roll back the systemic risks they pose to financial stability, the way they undermine long-term economic development, and the social injustices they are responsible for in our economies and societies.

In their report 'Hedge Funds and Private Equity – A Critical Analysis', the Party of European Socialists (PES) has further shown that the short-term concerns of buy-out groups and the long-term development focus of infrastructure operators collide in other areas too. These include research and development, training and investment in staff and pricing strategies [71]. Several of these conflicts are the same as in other types of companies taken over by private equity firms. However, when it comes to other types of companies, it is primarily the workers within the company that lose out from the prevalence of short-term profit-making. With regard to providers of public services, utilities and infrastructure, in addition to the workers it is all the people who depend on these in their daily lives. The inherent contradiction between the purpose of public service providers and the interests of private equity firms means that they are a fundamentally incompatible couple. But as they can be extremely lucrative to investors, fund managers increasingly put their weight behind such forced marriages.

The risky walk on eggshells

The private equity and hedge fund wave is still rising. 2007 will see more leveraged buy-outs than 2006, which itself was a record year. Hedge funds are similarly leaving the alternative investment domain to become mainstream asset classes of appeal to all kinds of institutional investors. That the wave will come down at some point seems inevitable. After all, it is not the first time history has witnessed leveraged buy-outs. And history shows that this phenomenon indeed is highly cyclical. The question is not 'if' it will come down but 'when' and 'how'. Will it be when the investment community realises that most funds, whether in private equity or in hedge funds, are as delusional as the emperor with no clothes? When the damage to workers and societies has become so detrimental that politicians and regulators have to act? Or simply when the bubble bursts? As has been shown in this chapter, that might well happen sooner rather than later. And it might be with a crash rather than a soft landing.

Ironically, it might very well be the perceived success of private equity and hedge funds that brings them down. Currently, their investments are extremely demand-driven. Money is pouring into the funds and their main difficulty seems to be finding opportunities to invest this new capital. Because of their fee structures, fund managers themselves will not cut back their deal-making. For every deal that is made, whether profitable or not, their income goes up. This is pushing up prices for companies and means that deals in the future will be less valuable. Indeed, there seems already to be an increasing phenomenon of private equity firms targeting companies in industries such as airlines and automobiles that appear highly unlikely to deliver the kind of returns these investors are looking for. Combine this acquisition mania, the higher prices that are being paid and the lower profitability of the deals with the levels of leverage presently being undertaken and the crashes cannot be far away. And the longer the crashes are kept at bay, the greater will be the pressure on labour, supply chains and the environment. All parts of the businesses will have to go further in their cost-cutting. All workers will have to deliver more for less.

No one is waiting or hoping for a crash. But if private equity and hedge funds are not regulated adequately it will become a reality. Policies must address the externalities as well as the deliberate exploitation by these protagonists of today's financialisation before such a crash takes place. Regulation must roll back the systemic risks they pose to financial stability, the way they undermine long-term economic development, and the social injustices they are responsible for in our economies and societies. The next chapter of this report sets out how this can be done.

III. Changing course: recommendations for a sounder, more equitable economy

Policies and Regulation

In spite of the recent explosion in private equity and hedge funds, the assets and amount of money they control and the people they ultimately employ as well as the growing influence they have on our economies and societies, these funds still operate in a policy and regulatory vacuum. Indeed, their increasing popularity over the last decades has owed a lot to this situation, as it has meant that the funds and the companies they acquire have been more or less 'hands off' for regulators and policy makers. Yet more directly focused, tougher policies and regulation are needed to handle the many risks, problems and challenges related to private equity and hedge funds that have been outlined in the previous chapters of this report. A paradigm shift in policy and in legislation, which ensures that the so-called alternative investment industry is no longer unregulated, is needed. Private equity and hedge funds must play by the same rules as everybody else.

Hard regulation is necessary – for hedge funds, for private equity arrangements and for other actors that replicate their activities. The funds, their investors and their owners will never succeed in regulating themselves adequately through voluntary codes of conducts and the like, although these are now emerging in both Europe and the US, for example on disclosure and transparency. While both the US Treasury and the Council of finance ministers of the European Union have welcomed such initiatives, they are wrong to argue that a soft, self-regulatory approach is sufficient, for hedge funds at least [72]. Only government regulation will be able to curb the externalities of these investment activities. The industries themselves will never address the prevailing pressure for destructive and unsustainable rates of return. And they will not find ways to channel financial resources into productive, long-term investment which can benefit society as a whole. They will never do what is needed: propose new, innovative regulation that includes measures to discourage quick-flips, ensures greater transparency and public reporting requirements, puts limits on the current debt and leverage extravaganza, ensures that tax rules are fair, and makes the funds meet their obligations as employers of thousands of people. Only governments and their regulatory bodies can do what is necessary and needed. And that is long overdue. [73]

Transparency

The transparency of private equity and hedge funds is an overarching priority which is fundamental to all the following issues requiring new policies and regulation. Without markedly more transparent workings of the so-called alternative investment industry, regulatory concerns regarding financial stability, taxation, corporate governance and workers' rights will not be met. Such transparency and disclosure must include both the funds themselves and the companies they remove from public stock listings. Private equity and hedge funds have benefited from operating in the shadows but in view of their growing influence on our economies and societies, there needs to be a limit to their secrecy.

There must be a level playing field between private equity and hedge funds and other, more traditional collective investment schemes with regard to reporting on performance, investment strategies, risk management models, debt layering, fee structures and the incentive mechanisms of their management.

There must, first of all, be a level playing field between private equity and hedge funds and other, more traditional collective investment schemes with regard to reporting on performance, investment strategies, risk management models, debt layering, fee structures and the incentive mechanisms of their management. Minimum reporting standards are required to ensure both accountability and a higher degree of consumer protection. Investors – not least pension funds – should be able to assess and compare financial returns and risks of the different types of funds. Hence, disclosure does not just concern supervisors and regulators but also the general public.

> Private equity funds in particular should report on the assets that they are holding, making it clear what these are and disclosing key economic, financial and employment data about them. This would mean that both the funds and their assets are removed from the opacity they currently operate in.

> In economies where hedge funds are still operating under different jurisdictions – such as in the EU – a unitary category for onshore funds should be established, including a common minimum investment threshold, thus ensuring a harmonised framework for these funds. In the US, Congress should restore full ERISA[74] coverage of hedge funds and give the Securities and Exchange Commission (SEC) clear power to regulate hedge funds as it regulates other forms of money management. Similar rules and regulations are needed elsewhere as well.

> Companies that have undergone private equity buy-outs and hence have been taken off public stock listings should not, past a certain size, be exempt from reasonable reporting requirements. Hence, governments and other regulators should extend the disclosure obligations of listed companies to all large private companies, which in practice should be determined by turnover and employment levels. As certain reporting requirements for listed companies – such as the obligation to produce quarterly reports – may themselves encourage detrimental short-term perspectives, regulators should consider reviewing such requirements to make them more consistent with their intended objectives.

Financial stability and systemic risks

The growth of private equity and hedge funds, and particularly their level of leverage through debt, means that they no longer only pose risks to individual investors but that their activities contain systemic risks that stand to have severe effects on financial markets. As pointed out in previous parts of this report, there is a risk that the current buy-out boom will drive equity valuations and debt leverage up to levels that will create volatility in markets. Many leveraged players whose exposure has grown substantially are already at risk. Their losses could be vast and would have serious consequences for investors, employees and many more.

Today, these asset classes represent a potent threat to the stability of the wider financial system. This is another reason why it is unacceptable that these funds are allowed immunity from proper public oversight. Financial regulators have already warned that both private equity and hedge funds pose systemic risks to financial stability, yet so far they have not proposed effective solutions to counter this risk. The

Regulators and policy makers should not only consider reporting requirements on the use of debt, but should also develop ways to put limits on the permitted level of leverage in deals and operations.

investment policies of private equity and hedge funds should generally be regulated according to prudential rules aimed at both financial market stability and long-term asset value creation. This means that disclosure requirements should be designed accordingly and that there should be limits to the leverage that funds can take on.

> First, due to the vast and reckless use of debt to fund their activities, it is necessary to increase the regulatory oversight applying to the private equity firms. Central banks – such as the Federal Reserve in the US and the European Central Bank – should regularly report on the overall exposure of the banks within their jurisdictions to leveraged investment activities of private equity and hedge funds. Private equity funds should report on the consequences that different economic and financial developments could have on the operational sustainability and employment obligations of the companies they own.

> As a general way of countering the systemic risks to financial market stability that are exacerbated by the opacity in which private equity and hedge funds operate, governments and Central Banks should establish a 'Basel III'[75] agreement covering the non-banking sector. By limiting the levels of leverage such funds can take on, this would lower the likelihood of them defaulting and hence going bankrupt.

> With respect to hedge funds, it is crucial to monitor their extensive use of derivatives. As a rather restricted number of prime brokers – about ten major investment banks – provide leverage for hedge funds, this can be done by requiring such brokers to periodically provide full disclosure of their exposure to different categories of financial risks.

> In relation to leverage, regulators and policy makers should not only consider reporting requirements but should also develop ways to put limits on the permitted level of leverage in deals and operations. Directly, this could be done by simple rules requiring that a specific part of a takeover bid or investment consist of equity. Indirectly, as will be shown in the next part of this chapter, it could be done by tax rules.

Taxation

Tax rules and regulations have been central for the emergence, growth and activities of private equity and hedge funds. Such rules and regulation presently favour the use of debt compared to equity in financing company takeovers and activities, and provide very generous terms for the managers and general partners of such funds. In consequence, the explosion of private equity but also hedge funds risks undermining many national tax systems and the government revenues that these generate. Indeed, as shown above, some governments have calculated that they will lose up to one quarter of the proceeds from company income taxes if private equity funds are allowed to continue to grow and operate as they presently do. Tax rules can be used to constrain the loss of public revenue due to private equity and hedge funds as well as to limit some of the negative aspects of leveraged buyouts discussed in the previous section.

When designing tax regulation in relation to financialisation it is important to distinguish between the taxation of the funds themselves, the fund managers and the companies owned by these funds. Generally, tax regulation should be reconfigured to cover hedge funds and private equity regimes in a way that ensures that tax systems are not biased toward short-term investor behaviour and so that the emergence of these funds does not jeopardise government revenues from corporate taxes.

> With regards to the companies that are taken over, tighter regimes should be

With regards to workers, mechanisms are required for representation, information and consultation of trade unions.

established to ensure that private equity ventures are unable to continue to reduce corporate taxation in the way they have been doing so far. This should be done by introducing rules that limit the deductions for expenditure on interest in the target company, its holding companies and its subsidiary companies once the target company has been taken over. The limitation could take the form of a prohibition of deductions for interest expenditure by the holding company that has been established to carry out the takeover. The limitation could also take the form of a removal of the deduction for interest expenditure by the target company in respect of interests on the debt incurred in order to pay an extraordinary dividend after the transfer of ownership. Regulation should, thereby, only be changed in such a way that borrowing for productive investment in real capital is not penalised.

> Concerning the fund managers, the problem is the tax treatment of carried interest, which is generally taxed at the much lower capital gains rate rather than at the normal income tax rate – for example at 15 percent rather than 35 percent in the US. This too urgently needs to change, and can rather easily. As it is obvious that such revenues are paid as a fee for a specific task or function, they should be taxed as income. All it would take to do this is for tax authorities to amend the rules and to enforce them quickly.

> With regards to the funds it becomes more complicated, since most hedge funds and private equity funds are incorporated in offshore tax havens and hence have their tax liabilities there. Two avenues should be pursued in order to minimise the negative tax effects. First, more should be done to restrain the use of such offshore centres, among other things through the work done by the OECD on harmful tax practices. Secondly, what might be even more efficient would be to change tax rules so that the location of the manager determines the tax position of the fund.

> In relation to the short-term behaviour of private equity and hedge funds another tax aspect worth considering is whether progressive capital gains tax rates can be applied in a way so that they are relatively higher for short-term arbitrage deals, and hence discourage the short-term buying and selling of firms on the market.

Corporate governance

Current national frameworks for corporate governance focus on publicly traded companies and have far weaker requirements for unlisted companies. As shown in previous parts of this report, this lack of corporate governance regulations with regard to unlisted companies entails a range of problems. These regard the independence of the board of directors, the division of roles between management and owners, and the inclusion of workers' representatives in governance structures. Another serious problem is the fact that there are no clear regulations on directors' involvement with possible buyout funds before and after a deal might be struck. This raises issues of loyalty, misuse of information and possible manipulation of shareholders. Furthermore, the asset stripping and recapitalisations undertaken in order to pay out dividends that often jeopardise the existence of otherwise healthy companies are clearly contrary to any notion of good corporate governance.

> Overall, the responsibility and powers of the boards of directors to preserve long-term interests of companies under private equity regimes, or whose ownership structure includes hedge funds, needs to be reconsidered so as to improve responsible business conduct and prevent conflicts of interests. New codes of conduct for boards and senior executives in case of a private equity takeover, to ensure that the interests of shareholders and employees are properly safeguarded, should be introduced.

Regulatory action must ensure that leveraged companies do not take on debt in order to pay out dividends.

Workers' trade union representatives must have sufficient information on the strategy and the business plan that the private equity firm intends to impose on the management of the company.

> To ensure that long-term investors have the strongest influence on companies, the latter type of investors could be rewarded by permitting weighting of voting rights according to the duration of shareholding and by means of differentiated taxation of income from shareholders. In order to prevent value extraction, limitations on the withdrawal of liquid assets from the target company should be introduced.

> Another avenue worth exploring is whether capital maintenance provisions that prescribe limits to the transfer of debts to companies that are the object of buyouts could be introduced. This could be done through the restriction of credit financing and would help ensure that companies are not overloaded with the very debt that has been used to acquire them.

> The emergence of private equity and activist hedge funds shows that there may be a need to give a new push to the so-called 'Rhineland model' of public companies. This model guarantees the engagement of all parties with a stake in the company including unions, communities, investors and others. If regulators were determined to promote this model, fund managers would have less leverage to continue disregarding stakeholders as they presently do. With regards to workers, this would mean that due consideration would be given to trade union representation, information and consultation mechanisms, as happens in many countries.

> With regard to hedge funds, reporting requirements should not only include assessment of risks and returns but should also look at the social impact of investments, particularly with regard to employment.

Finally, there is a need to look into the question of dividend payouts through recapitalisations. They are a way of extracting value from corporations that only benefits the private equity funds that own them and acts to the detriment of both the companies themselves and anyone involved in them. Surprisingly, they are at present fully legal – even if the company they take place in goes broke because of such dividend recapitalisations. Regulatory action must ensure that leveraged companies do not take on debt in order to pay out dividends.

Workers' rights

Private equity and hedge funds have a track record showing scant respect for workers' rights. Again and again, workers have been neglected or directly undermined by these actors. Indeed, as shown in previous parts of this report, the private equity business model and the management practices generally applied by the companies they own are in stark contrast with sound industrial relations, social partnership and investing in the workforce. In the short term, regulation may not be able to change either the business model of private equity or the management practices that private equity companies employ. But what regulation can and should do, starting right away, is to ensure that trade unions have enough information and that they are consulted on the future of their workplaces.

> In general, workers' rights to collective bargaining, information, consultation and representation within their workplaces should be regarded as key mechanisms by which the long-term interests of private equity-backed companies can be secured and promoted. In particular, workers' trade union representatives must have sufficient information on the strategy and the business plan that the private equity firm intends to impose on the management of the company. Trade union representatives of firms involved in buy-out deals should be informed about where the money comes from and who the ultimate investors are.

Pension fund managers, trustees and fiduciaries should consider investments in private equity and hedge funds very carefully.

> Governments should therefore look into how to introduce additional protections for workers affected by private equity takeovers. The most important step is to uphold the employer responsibility of private equity firms. This can be done in different ways in different countries and jurisdictions. In the EU in general, it would be by amending the Acquired Rights Directive. In the UK in particular, it would be by changing the Transfer of Undertakings (Protection of Employment) Regulations of 2006 (TUPE). Such regulations ensure continuity of employment terms and conditions during regular takeovers but they do not apply when ownership is transferred in deals that include all the shares of a company. That must change.

> The private equity industry should reach agreements with unions on rights to information and consultation during takeovers. Such agreements should not just cover employment relations in companies already owned by private equity firms but also ensure the respect of terms and conditions of workers in companies prior to takeovers and in future sell-offs. Hence, they should guarantee that workers will face no changes in their terms and conditions without prior collective agreements. Furthermore, they must guarantee that the workers' right to organise in trade unions will be preserved or respected where such rights do not already exist. Finally, they should ensure that the terms and conditions of employment as well as trade union rights continue to exist when a company is sold from one private equity firm to another, re-listed on the public stock markets or in any other way sold off.

Protection of public services and utilities

As private equity increasingly invests in public services and utilities, policy makers and regulators should consider seriously how to ring fence these from the risks, abuses and conflicts of interests that are inherent to such takeovers.

They must, first of all, ensure sufficient transparency with respect to all transactions affecting the implementation of existing public service responsibilities, including investment and expenditure, as well as the periodic reporting of indicators of public service performance, and powers to act if the public service objectives of government policy are not met.

Governments may wish to consider whether they should retain a 'golden share' of equity in all public utilities, including a seat on the board. This would ensure that the government is informed of the utility's plans and major decisions, and reserves the power to veto decisions they believe are contrary to the public interest.

Furthermore, governments should consider whether they need to strengthen industry-specific regulation with regard to infrastructure to make it sufficiently effective, establishing specific powers to regulate the financial as well as the operational activities of infrastructure providers. Indeed, for all their major financing activities, infrastructure operators could be required to obtain advance approval from the regulator regarding whether these are in the public interest.

An international regulatory task force and other work in the international realm

As private equity and hedge funds operate globally, it is necessary to look into what forms of international regulation should be enacted to ensure that these types of investment funds act in the general interest of our societies.

> To explore this issue, an international regulatory task force on private equity and

The loss of a job today, a pay cut tomorrow or a more insecure work-life in general will not be offset by a marginally higher pension in the distant future – should it transpire.

Pension funds and their trustees should be particularly aware of hedge funds that choose an activist shareholder status, with the intention of influencing management to deliver high short term returns.

hedge funds including the OECD, the IMF, the Financial Stability Forum, relevant UN agencies and the ILO should be established.

> In the meantime, organisations like the OECD and IMF that already assess the stability of financial markets should look more closely at the risks of highly leveraged market actors such as private equity and hedge funds, as well as propose ways to limit such risks.

> The OECD should address the issues that have been highlighted in this report with regard to corporate governance in its work on this subject, and take up the concerns regarding workers' rights where appropriate.

> The ILO should look further into how workers' rights are undermined during leveraged buy-outs and how the business model of private equity and activist hedge funds risks impairing long-established traditions of industrial relations.

Pension funds

Pension fund managers, trustees and fiduciaries should consider investments in private equity and hedge funds very carefully. As pointed out in previous parts of this report, due consideration should be given to both the profitability of such investments and the direct or indirect impact they may have on the workplaces of the owners of the pension plans. Trustees have a special responsibility in ensuring that investments are socially responsible and undertaken with a long-term perspective. They must make sure that those who manage the pension funds on a daily basis understand and respect the priorities of the funds.

Private equity

If pension funds consider investing in private equity funds, they and their trustees should first of all not be fooled by the hype currently surrounding private equity. The alleged high returns that are often associated in the mainstream media with this type of investment have so far proven to be fund-specific and not general for the industry. On average, investments in private equity have not been more profitable than their counterparts in public equity on listed markets.

Furthermore, they and their trustees should be aware of and consider carefully the consequences of the non-liquid nature of these investments, of the difficulties regarding benchmarking and valuation, of the inefficient nature of private equity markets, of the high fees associated with these funds, of the irregular cash flow characteristics that such investments have, of the fact that it is a type of 'blind pool investing' whereby the investor does not know what particular investment opportunities the investment manager will pursue, and that they risk not just getting low returns but also losing the principal of their investment.

Finally, they and their trustees should take into account whether the strategies of the funds they are considering investing in are in line with the long-term obligations they have as pension funds. Related to this, they should in particular pay due attention to the fact that even a profitable private equity investment might not be in the interest of the members of the pension fund, due both to the economic model that private equity represents and to the employment relationships that private equity is notorious for promoting. The loss of a job today, a pay cut tomorrow or a more insecure work-life in general will not be offset by a marginally higher pension in the distant future – should it transpire, which as noted above is far from guaranteed.

Hedge funds

If pension funds consider investing in hedge funds, they and their trustees should be aware of the fact that for the last four years, hedge funds have not delivered better results than other types of investment schemes such as mutual funds. The main characteristic of hedge funds as an asset class is that they rely more on 'alpha' than 'beta' returns, and hence have a chance of making money when markets in general are declining or contracting. With this in mind, they should compare the average returns that hedge funds in general generate with the much higher risks and often exorbitant fee structures that are a part of investing in hedge funds.

Pension funds and their trustees should be particularly aware of hedge funds that choose an activist shareholder status, which means that they buy a considerable minority stake in a given company with the intention of influencing management to deliver high short term returns – often by splitting up companies, promising special bonuses to management, and ultimately replacing existing management with their own appointees. In relation to this, pension funds and their trustees should pay due attention to the social policy of the hedge fund(s) under consideration. And they should, not least in their own interest, be aware of the publicity exposure of investing in hedge funds that aim at short-term returns through an activist shareholder's role, as these often come at the expense of less activist, long-term shareholders or the employees of the company under siege.

If pension funds do invest in hedge funds, they should take their shareholder responsibilities seriously by attending shareholder meetings, making their voice heard and ensuring that the fund acts in accordance with the principles of the pension fund in all its dealings with companies. In general, pension funds and their trustees must make high demands on the socially responsible investment policy of external asset managers, as these increasingly invest in hedge funds.

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