

EXCLUSIVE: Mark Kritzman on the Fallacy of Portable Alpha

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For Marathon Asset Management founders Louis Hanover (left) and Bruce Richards, investing is a race marked by discipline, endurance — and opportunism

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An Activist Alternative

By Kevin Dolan

The much-publicized credit crisis, which began in the U.S. subprime mortgage market and quickly spread to all corners of the globe, has had more than its share of unsuspecting victims. Private equity firms, which rely on leverage to finance deals, in particular have been hurt by the sudden unwillingness of banks to lend on any terms, let alone the favorable ones that had driven the buyout boom of recent years. Big private equity players have had little choice but to retreat from megadeals. In October, Cerberus Capital Management withdrew its \$6.2 billion offer to buy Affiliated Computer Services; the next month the firm announced it was walking away from its planned \$4 billion purchase of United Rentals. In December, J.C. Flowers & Co. pulled out of a \$25 billion joint bid with Bank of America Corp. and JPMorgan Chase & Co. for SLM Corp., owner of student loan company Sallie Mae.

Private equity firms are feeling the credit crunch, but their pain could mean opportunity for activist hedge fund managers.

The harsh reality of the credit market is likely to make it difficult to take companies private for the next 12 to 18 months, forcing private equity firms to choose their targets carefully. It is also likely to create tremendous opportunities for activist hedge funds, which do not rely on bank funding or leverage, to fill the void and extract value from underperforming public companies.

Hedge funds have proven on many occasions that companies do not have to go private to execute a proper restructuring. The success of Nelson Peltz's Trian Group with ketchup maker H.J. Heinz Co., William Ackman's Pershing Square Capital Management with McDonald's Corp. and Christopher Hohn's the Children's Investment Fund Management (UK) with Dutch bank ABN Amro are just a few recent examples. These are among the true activist funds, which we call active-value partners or active-value investors. They have a private equity mind-set and are long-term, deep-value investors. They approach investments with detailed shareholder-value enhancement plans and the expertise to advise managements on how to execute them. They use public activism tools like proxy fights only as a last resort and, for the most part, operate under the radar.

True activist managers typically demand longer lock-

ups from their investors — which allows them to employ significant patient capital — and invest alongside other shareholders for as long as necessary to usher in change. These managers appreciate that it isn't easy to turn around large, monolithic organizations and view themselves as partners with the companies in which they invest.

Not all activists are value partners. Some hedge fund managers make short-term investments in undervalued companies and shake the tree publicly and aggressively, hoping for stock appreciation. These managers, who we call noisemakers, tend to have short lockups — in many cases promising their investors monthly liquidity — and thus are unable to engage companies in a long-term restructuring plan. Their attention-grabbing strategy is designed instead to put a company in play, but as leveraged buyouts and other acquisitions dry up, they can no longer count on multiple bidders to drive up stock prices and ultimately buy out their positions.

A recent report by Thomson Financial found that activist funds have been successful in influencing corporate strategy in their favor 63 percent of the time. We feel the success rate is quite a bit higher with true active-value investors. These managers often bring significant operational expertise. They also tend to focus on specific industries, allowing them to specialize and understand the nuances and challenges of a given sector. TCI has clearly made its mark in the financial and exchange sectors, while Trian has been very successful with food and beverage companies.

In the face of the current credit crisis, private equity returns are likely to be compressed for the foreseeable future. As a result, pension funds and other institutions with billions of dollars earmarked for private equity investments may be searching for an "alternative" alternative vehicle. One place they may want to look are activist hedge funds. These managers should be able to produce good risk-adjusted returns while also offering shorter lockups than those of private equity funds — which typically require a capital commitment of seven years — more transparency and a hedged portfolio. The best of these operational activist hedge funds will continue to proactively build alpha for their investors and create upside for all shareholders.

Kevin Dolan is chief executive of La Fayette Investment Management, a fund-of-hedge-funds firm with \$6 billion under management. La Fayette is headquartered in London and has offices in New York and Geneva.