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Superstars in the Emperor's New Clothes

Hedge Funds and Private Equity Funds What is at Stake?

Briefing Paper

by

Peter Wahl

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The views expressed in the paper are those of the author.**

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SUMMARY

Hedge Funds (HFs) and *Private Equity Funds* (PEFs) were the superstars in the canopy of the financial markets in the nineties. In recent years they have become a controversial issue. With the present crash, even more questions have been raised, as the HFs, among the different factors, played a prominent role with respect to responsibility for the disaster.

This paper looks at *Hedge Funds* and *Private Equity Funds* very much as a subclass of the more general type of *institutional investors*. HFs and PEFs are two special cases of this type of actors which is shaping the contemporary international finance system to a large extent. The institutional investor is at the centre of a new mode of accumulation which emerged after the end of Bretton Woods. The concept of institutional investor describes a historical change in the function of ownership. The rather passive function of traditional ownership has been transformed into a systematic economic activity. It has been professionalized and institutionalised. The search for the maximum profit in the shortest term possible becomes the only rationale in the activities of institutional investors.

The new structure was called the *shareholder-value regime, asset and wealth driven economy, or finance capitalism*. Whereas previously financial markets had a subordinate and instrumental role to the real economy, this relationship has been turned around. This change affects the entire society: economy, social structure, politics and culture. Hedge Funds and Private Equity Funds are the most advanced expression of the spirit and dynamics of the shareholder-value regime. They are the vanguard of the new asset-driven and wealth-oriented type of economy.

The new system has particular consequences on the following three areas:

- financial stability: systemic instability has considerably increased;
- distribution and equity: the new system leads to a constant redistribution from below to above;
- policy space or democracy: the transnationalisation of finance creates transnational spaces, which prevent the individual nation state from exercising regulatory access. Democracy is both historically and structurally inseparably connected with the territoriality principle of the nation state.

Hedge Funds and Private Equity Funds are strong catalysts in implementing the new regime of accumulation. The business model of HFs is characterised by high leverage and intransparency. Mostly based in Offshore Centres they are not supervised and regulated. The model brings the logic of the shareholder regime to perfection.

HFs are growing fast in terms of assets, activities and number. They have considerable market shares in certain sectors of the financial markets.

Hedge Funds are heavily involved in the present crash and suffered from dramatic losses. They had a high share of trade in complex derivatives, which were at the root the crisis. The crisis has shown that the attributing a risk reducing role to the HFs is like assigning the position of fire prevention to a pyromaniac.

HFs have begun to expand to emerging markets, thus transferring the specific risks of these players to the target countries.

A specific risk of HFs not only for emerging markets but for other developing countries derives from the reaction of HFs to the present crisis. Given that the traditional areas of business are drying up, they reorient their deals among others towards speculation with raw materials, oil and food. This leads to an increase in prices. This particularly hits the oil importing countries and those who depend on raw material and food imports. The rising food prices have in some countries led to riots.

The paper argues that Hedge Funds don't have any useful function for national economies or the world economy. They are sheer cash machines for speculators. Therefore, it would be the best, to ban them. As long as the political balance of power does not allow for that, regulation should aim at transparency, including fully into supervision and limiting leverage to a sustainable level.

Just as with Hedge Funds, Private Equity Funds only became a relevant factor when the financial markets were liberalised and deregulated. The business model of PEFs has many similarities with HFs. The decisive difference to HFs is that PEFs don't invest into portfolio speculation but in the real economy. They buy a company for the purpose of reselling it at a profit three to six years later. Once a

PEF has gained control over a company it is subject to restructuring, i.e. laying off of personnel, cancellation of social benefits, outsourcing, filleting, etc. Therefore, they often are called "locusts".

Quantitatively PEFs are less important than HFs. Nevertheless they are a catalyst for subordinating the behaviour of management to the logics of shareholder orientation. They serve as conveyor belt for the asset and wealth driven model of economy to the whole economy.

PEFs are also beginning to be active in developing countries, in particular in emerging markets. 6% of all PEFs investment in 2005 was outside industrialised countries. They are particularly active in mergers and acquisitions. The Petro-Dollar economies are a main source of PEFs in developing countries.

Unlike Hedge Funds, Private Equity Funds might have positive effects in certain cases, if they are properly regulated, for instance as venture capital. However, this requires limitation of leverage, supervision and participation in decision making of the management through stake holders, first and foremost employees and trade unions.

Parallel to regulating PEFs, alternatives for company funding should be developed. In particular the "traditional" type of finance through bank loans should be restored, by creating incentives for banks to provide capital, including venture capital.

Berlin, April 15th 2008

Superstars in the Emperor's New Clothes

Hedge Funds and Private Equity Funds - What is at Stake?

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Peter Wahl

Hedge Funds (HFs) and Private Equity Funds (PEFs) were the superstars in the canopy of the financial markets in the nineties. In recent years, however, they have become a controversial issue. While EU commissioner McCreevy is totally enthusiastic about the funds: "Private equity houses and activist fund managers of all kinds – including hedge funds – play a much more valuable role than any government or any regulator in reducing the cost of capital",¹ the former German vice chancellor, Müntefering accused them of "remaining anonymous, having no face, pouncing on firms like locusts, feeding off them and moving on."²

The German presidency of the G8 2007 called for more transparency of HFs. The British and the US government were strongly opposed. The result was a weak compromise, which reads as follows: *"The global hedge fund industry should review and enhance existing sound practices and benchmarks for hedge fund managers; in particular in the areas of risk management, valuations and disclosure to investors and other parties in the light of expectations for improved practices set out by the official and private sectors."*³

Nine months later, the present financial crash⁴ throws an interesting light on the HFs. This is because the HFs, among the different factors, played a prominent role with respect to responsibility for the disaster. It might well be that the glamour and glitter of the financial market's heroes will finally turn out to be like the emperor's new clothes.

Now, under the pressure of crisis, even the financial community mainstream calls for reforms. But as always in such situations, the reforms will be controversial. Everything will depend on whose interests will shape the reforms. If bankers call for state intervention, they mean socialising losses, while keeping profits in private pockets. If they talk about reform they mean a piece-meal (re)regulation and short term crisis management and trying to return to business as usual after a while.

Changes where finance has to contribute to social equity, economic stability and sustainable development are what are needed. A return to the status quo ante should not be permitted. The failure of the dominant model has never been so obvious as it is today. It is largely discredited. Consequently, a historic window of opportunity is opening. Civil society should use the opportunity to intervene in this debate.

Most of the literature available on HFs and PEFs has been produced by the private financial industry, finance ministries, financial controllers and central bankers. The assessment ranges from unreservedly positive to basically positive with some concerns restricted to the stability risk. A small number of comments has raised questions concerning the distributionary effects, labour, the social dimension and

¹ Reuters, Feb. 20, 2007, London.

² Bild am Sonntag, 17 April 2005.

³ Communiqué of the meeting of G8 finance ministers in Potsdam, 18/19 May 2007.

⁴ This text was completed at the end of March 2008 when the crisis had reached a certain peak, but its end was not yet in sight.

power relations, dominance and democracy. Neoclassical theory even externalises these questions as being alien to economics.

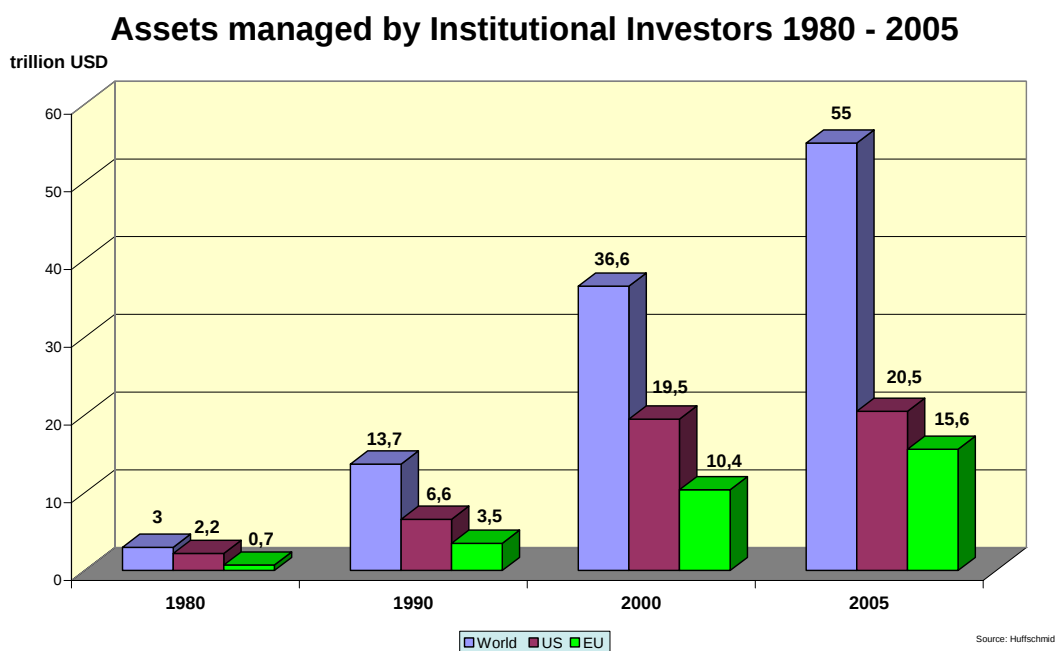
We, in contrast, consider this epistemological blind spot as being ideologically biased and attempt to take into consideration the complexity of socio-economic reality within the tradition of political economy. This also implies a macro-perspective. At the micro level, all the issues and problems of HFs and PEFs with regard to their performance, their governance, and all the technicalities of their business are only relevant to our perspective to the extent that they have an impact at the macro level.

We hope to contribute to raising awareness on one - nevertheless an important - dimension of the present financial system and to strengthen the debate with respect to a new and democratic governance of the international finance system.

1. Institutional Investors – the core of finance-dominated globalisation

Hedge Funds (HFs) and *Private Equity Funds* (PEFs) are two special cases of a new type of actor in the international financial markets: the *institutional investor*.⁵ Thus, everything that is said in this chapter also applies to HFs and PEFs.

Chart 1



The institutional investor is at the centre of a new mode of accumulation which emerged after the end of the Bretton Woods System and reached its climax over the last ten years. Institutional investors include investment banks, all kinds of investment

⁵ In the literature of the finance community, HFs and PEFs are sometimes classified under the title "*alternative investment*" or "*special purpose vehicle*" - together with works of art.

funds (including HFs and PEFs), pension funds, Real Estate Investment Trusts (REITS) and all varieties of insurance companies which operate in the financial markets. Large corporations can act as institutional investors as well. Foundations and endowments also increasingly participate in the game. The whole sector has grown considerably over the past two decades, from globally 3 trillion USD in 1980 to 55 trillion in 2005. This is an increase of 1,833% (see chart 1).

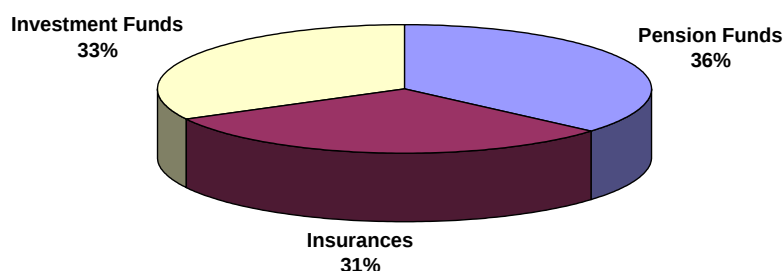
The concept of institutional investor describes a historical change in the function of ownership.

1.1. The transformation of the ownership function

The traditional owner held his shares, bonds or other securities and received a dividend or a disbursement once a year according to the performance of the company, the bond rating etc. Normally he held his assets over the long term, covering many years. Of course, sometimes the shares would be sold, if for instance the shareholder needed cash, but this was normally not the consequence of a systematic economic activity.

Chart 2

**Distribution of total assets (55 trillion USD)
on type of investor 2005, in %**



Source: Hufschmid

Source: Hufschmid 2007

The institutional investor does not buy shares and bonds for the sake of the dividend or an annual disbursement, but for the purpose of reselling it at a higher price as soon as possible, and to purchase again and to resell again, and so on and so forth. In other words, the rather passive function of ownership has been transformed into a systematic economic activity. It has been professionalized and institutionalised in the institutional investor. The institutional investor is permanently and systematically looking for opportunities to increase the value of his assets with the aid of highly sophisticated, computer model based methods, and using advanced technologies.

The whole development has been made possible by the liberalisation and deregulation of the financial markets in the post Bretton Woods era. The lifting of capital controls together with the new technical possibilities for moving huge quantities of money from one place of the globe to another with a mouse click lead to the emergence of completely new profit opportunities through trade in currencies, bonds, securities and derivatives, by using the differentials in exchange rates, interest rates and other asset prices.

If enough money is used, even a slight difference in the exchange rate, the interest rate or varying prices of financial assets can yield enormous profits. A typical example is *carry trade*, i.e. using the interest rate difference in various countries. If, for example, I take out a loan over 100 million USD from a New York Bank at the US interest rate of 4% and then transfer it to Brazil where I lend it as a short term credit for one month at the Brazilian interest rate of 16% before paying it back in New York, I make a gross profit of one million USD.⁶ Institutional investors carry out thousands and thousands of such deals every day.

It is obvious that the quantitative dimensions and the complexities of these operations require professional know-how and an institutionalised base.

Carry trade is a sub class of a basic type of deal on the financial markets: *arbitrage*. Arbitrage is the use of an already existing and known difference in exchange rate, interest rate or any other asset price. The second basic type of deal is speculation. Whereas arbitrage is a safe business with guaranteed profits, speculation always carries a risk, because it is a bet on a future difference in the asset price.

1.2. The shareholder-value regime

All this has led to a dramatic acceleration in the financial markets and increased its systemic volatility and instability. However, a lot of business and particularly the most profitable part lives off that volatility and instability. The more volatility there is, the bigger the business and the profit opportunities. For instance, in a system with fixed exchange rates, you cannot earn money by trading in currencies.⁷ The exit option for an investor, and thus short-termism, is limited in a system with capital controls.

The new financial system offered average profits which were twice the figure normally possible in a real economy. Leading players in the finance industry even reach 25% return on equity and more. Of course, the result is that investors prefer to put their money into the financial industry rather than into the real economy. Thus, one consequence of these developments is a relative structural underinvestment in the real economy with a resulting negative impact on growth and employment on the one hand (Chesnais 1996), and a disproportionate orientation towards financial asset and wealth creation on the other hand.

The search for the maximum profit in the shortest term possible becomes the only rationale in the activities of institutional investors, if political regulation does not impose limits.⁸ The logic of maximum profit applies, as we will see later in detail, particularly with regard to HFs and PEFs.

⁶ The gross profit in this deal has been delivered from the Brazilian economy, which has to earn the million which then occurs as outflow in the country's capital balance.

⁷ Except for brokerage fees, which are not really relevant.

⁸ This is normally the case for pension funds where there are legally imposed requirements for prudential investment which are intended to prevent the funds from taking risks that are too high.

1.3. Spill over into real economy

Another consequence of this trend is that the real industry has come under pressure to deliver returns similar to those of the financial industry. This is why we witness the process of the financialisation of the real economy, a transfer of the operational logic of the financial markets to the real economy. Key elements are:

- Company financing through financial markets. Credits were transformed into tradable securities. The process of securitisation is a basic trend. On the one hand, the credit risks of the banks are thus transferred to other market participants. On the other hand, corporations today no longer obtain their finance from the “home bank” but from financial markets. In the traditional type of financing, the “home bank” and the company were linked through the creditor-debtor relationship. The creditor knew his debtor well and had an interest in that company flourishing, to insure that his loans were serviced;
- The threat of unfriendly takeovers forces registered companies to primarily pay attention to their stock price (price nursing). Other goals, such as long term competitiveness, technological innovation and job creation have to take second place. *“Takeovers came to represent perhaps the dominant form of organisational transformation among large capitalist firms”* (Davis/Stout 1992:606);
- Orientation of management towards an asset driven type of economy. This occurs through different instruments. For instance, a large proportion of management remuneration consists of company share options, thus creating an incentive for managers to keep the stock price high. Another instrument is the “golden parachute” i.e. fabulous compensation - an incentive to take high risk.

In 1986 already, the entirely new structure was called the *shareholder-value regime* (Rappaport 1986). Others named it *investor capitalism* (Useem 1996) or speak of *finance capitalism* (Windolf 2005). Whatever you call the new phenomenon, one thing is clear: whereas in previous times financial markets had a subordinate and instrumental role to the real economy, this relationship has been turned around. This change was the trigger, and still is the centre and the engine of the present wave of globalization, which could also be called a qualitatively new stage in the history of capitalism. It is more than just a shift in the economy. It is a new model or mode of accumulation – driven and dominated by the finance sector - and its activities affect the entire society: economy, social structure, politics and culture.

Hedge Funds and Private Equity Funds are important elements in this process. They are the most advanced expression of the spirit and dynamics of the shareholder-value regime. They are the vanguard of the asset-driven and wealth-oriented type of economy.

1.4. Consequences of the shareholder regime on stability, development, equity and democracy

As already mentioned under point 1.2., the new financial system is based on and lives off volatility at all levels. Thus, when stability risks are discussed in the mainstream of the financial community, stability in this context means only the non-collapse of the system. Therefore regulation is mainly conceived to be applied at the

micro level. For example, exchange rate volatility should be buffered by derivatives, but options like exchange rate corridors, fixed exchange rates or even the establishment of regional currencies, such as the EURO are blanked out at the macro level.

Nevertheless, there is a broad consensus that financial instability has increased considerably over the past 30 years. One indicator is the frequency and the impact of major financial crashes: 1994 Mexico, 1997/98 South East Asia, 1998/99 Russia and Brazil, 2000 the crash of the "New Economy", 2001 Argentina and the present situation, the crash triggered by the sub prime mortgage crisis which started in 2007.

The developing countries and vulnerable groups are the main victims of instability. The losses from these crashes suffered in the developing world during the last 25 years are estimated to be a quarter of their GNP. Over half of the Argentinean population were forced below the poverty line after the crash of 2001. But those countries in which the crash occurred were not the only ones affected. Indirectly, others were also sucked in. For example, Laos was hit harder than Thailand by the crisis because 80% of Laos' foreign trade is with Thailand.

But the volatility and hectic activity on the markets means permanent economic stress and costs for the developing countries, even when there is no crisis on the horizon and the financial markets are functioning "properly". Taking all factors into account, this leads to an uncertain and incalculable economic environment.

There is a constant redistribution from below to above which is beyond the distributionary effect of crisis. One indicator is the increase in liquid assets of HNWIs.⁹ The financial assets of this group have doubled worldwide between 1995 and 2005 from 16 to 32 trillion USD according to the *World Wealth Report*. At the same time, real wages have stagnated or even decreased and poverty has returned to many industrialised countries. However, these phenomena are not limited to the industrialised world. The increase in liquid assets of African HNWIs in 2006 alone was twice the amount (62 billion USD) of the total development aid to the region. The *World Wealth Report* explicitly states that alongside the boom in raw materials, the decisive factor was the increasing portfolio investments of African elites in the financial markets.

Money is not only an economic factor. Having large sums at one's disposal can also be used for the acquisition of political influence. And the common interests of big money is the basis for a powerful lobby which may have considerable influence not only on decision making but also on the public and on the values and general orientations of a society. Aristotle said: "*The point at which democracy and oligarchy differ, is poverty and wealth.*" Any analysis of the processes of financial markets which does not consider the power relations which are combined with economic relations will fail to match reality.

The influence of financial markets on governments, whose decisions can affect the fate of millions of people leads to an erosion of democracy. Many political decisions are forced on governments because of factual constraints caused by investment decisions and competition between different geographical locations: The former head of the Deutsche Bank, Breuer, called the financial markets the *Fifth Power*.¹⁰ "*Investors need no longer look for opportunities which governments offer them, but governments have to meet the wishes of the investors.*"

⁹ Persons with liquid assets – i.e. excluding real estate property, luxury goods etc. – from 1 million USD upwards.

¹⁰ Alongside the legislative, juridical, executive power and the media.

The central problem is that the transnationalisation of finance creates transnational spaces, which prevent the individual nation state from exercising regulatory access. However, parliamentary democracy is both historically and structurally inseparably connected with the territoriality principle of the nation state. The national territory and its citizens are the basis of democracy, whereas transnational spaces are not subject to democratic control. Democracy beyond the nation state does not as yet exist.

2. Hedge funds - a spearhead of the shareholder regime

Hedge Funds are a subclass of institutional investors. They are part and parcel of the shareholder regime described above. We want to analyse to what extent there are additional specific characteristics of HFs which go beyond the general features of institutional investors in this chapter.

The name *Hedge Fund* appeared for the first time in the late 1940s. A certain *Alfred Winslow Jones*, a journalist working for the magazine *FORTUNE* in the 40s, had established a speculative fund. From the start, his activities had nothing to do with hedging in the sense of protecting against unforeseen price changes in the real economy, although the PR of HFs and their Lobby sometimes continue to maintain this illusion. However, under the conditions of the Bretton Woods system with its fixed exchange rates and capital controls, HFs were an exotic side note of no importance.

Because of their extremely speculative character, they were prohibited in some countries, including Germany, where they were only allowed in 2004. Certain operations such as *short selling*¹¹ are still de facto prohibited. Short selling is speculation with assets which the speculator does not (yet) own through the use of derivatives. Imagine the following example: on the 10th of September, you buy a future (or an option)¹³ which means you contract to sell shares of *American Airlines* with an overall face value of 10 million USD at the rate of September 10th, although you do not own a single share of this company at this moment. On the 11th of September, the value of the *American Airlines* shares suddenly decreases by 40%. On the 12th, you now buy (with a short term credit, if you like) the number of shares you have contracted to sell. However, as the rate has decreased, these shares are now 40% cheaper. You then present your contract and sell the shares for the higher fixed price of September 10th. Your gross profit is 4 million USD.¹⁴

2.1. The business model of Hedge Funds

The new finance system emerging after the collapse of Bretton Woods opened the way for new business models and new actors, among them HFs. They lost their exotic character and were increasingly accepted as an “innovative” business model. Hedge Funds became mainstream. In 1992, George Soros, the famous manager of the *Quantum* HF, carried out a successful speculation against the Bank of England which ended in a depreciation of the British Pound Sterling. All major banks have

¹¹ “Leerverkauf” in German.

¹³ A future is a derivative, i.e. a contract which guarantees you an underlying deal in the future to fixed conditions in that contract. An option gives you the possibility to make the deal or not to, as you wish.

¹⁴ There were rumours that Al Kaida had in fact made such operations in Offshore centres. The US government issued a dementi. Nevertheless, if there was some progress in combating money laundering in the OFCs it was mainly due to measures taken by the US in the framework of their war against terror.

also taken up the model and established Funds of their own, which, however, operate as a legally separate entity.

HFs from an institutional perspective are organised either as a single fund, i.e. one pool for deposits or as multi fund, where several funds are managed under the roof of one company ("Fund of Fund").

The increasing acceptance of HFs has also led to the emergence of a variety of funds. However, there are some basic elements of this business model which are common to all HFs:

- Not everybody has access to a HF, which is unlike for public retail funds. There are minimum requirements for deposits, often one million USD or more. This means that investors have to be either rich individuals or institutional investors themselves;¹⁵
- HFs have been created to make above average profits. A minimum target for returns is set, the so called *hurdle rate*. Such a performance is only possible through high risk financial speculation, for example, by *short selling*, as described above, and deals with particularly risky instruments such as *structured products* and other derivatives. They speculate on currencies, on share prices, bonds or prices of raw materials. Speculation and the use of derivatives is a basic feature of the business model; the bulk of these transactions are carried out "over-the counter" (OTC), i.e. without any regulation and supervision.¹⁶ This is also the reason why there is a lack of transparency in the operations of the HFs. Nobody really knows what is going on and where the risks are;
- Supervision and regulation are very inconvenient for the ability to reach maximum profits. In addition, being domiciled in an OFC, means that no or less taxes have to be paid. This is why the majority of HFs (about 60%) have their legal base in offshore centres (OFCs). The *Cayman Islands* have the highest concentration of HFs (63% of the assets), followed by the *British Virgin Islands* (13%) and the *Bermudas* (11%). In Europe the British territories of *Jersey*, *Guernsey* and *Gibraltar*, as well as *Luxemburg*, *Liechtenstein*, and *Monaco* are home to HFs. The management, however, is based in the big financial centres, New York, London etc. The US is the biggest onshore¹⁷ site (48%), followed by *Ireland* with 8% (*IFS 2007*).¹⁸
- HFs work with leverage, i.e. they boost their own assets with additional borrowing in order to carry out their operations. Thus, the bigger ones can easily attain an operational capital which ranges in the sphere of billions of USD. The US HF *Long Term Capital Fund*¹⁹ which was on the brink of collapse in 1998, had borrowings 30 times its own assets. It is not surprising that the Fed undertook an emergency operation to save
- An increasingly important field of HF-activity is "*shareholder activism*". HFs purchase a significant number of shares of a certain company in order to influ-

¹⁵ There are some Funds which have lowered the minimum deposit, in some cases considerably. However, this is rather exceptional.

¹⁶ In general 80% of the trade in derivatives is OTC. The rest is traded at the stock exchange as standardised products which are subject to supervision (Lipke 2003).

¹⁷ Onshore is a rather relative concept in this connection. This is because almost all US onshore HFs are registered in Delaware. This US state has extremely liberal corporate laws which come close to those of an OFC. Ireland is a similar case.

¹⁸ www.ifsl.org.uk

¹⁹ The fund had two Nobel prize winners for economy on the board.

ence its decisions. Typically, this aims at the promotion or prevention of mergers and acquisitions, or other measures to restructure a company²⁰ or the payment of higher dividends to the shareholders. Hedge Funds played a prominent role in recent M&As such as the acquisition of the Dutch bank ABN Amro by the Royal Bank of Scotland and the Spanish bank Santander in October 2007. This was the biggest merger of banks in history with a value of 70 billion Euro.²¹ The takeovers usually lead to share price increases for the respective enterprises;

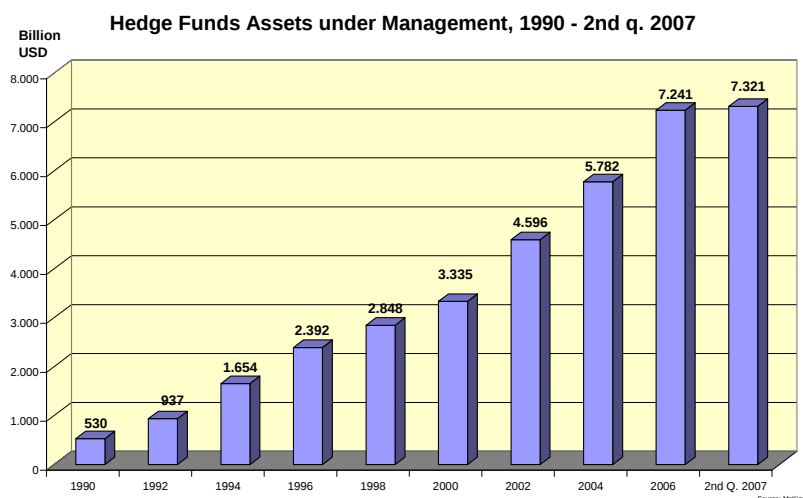
- At the micro level, shareholder activism also serves as a conveyor belt for the shareholder regime to those companies where they hold shares. The regime is penetrating step by step into the respective industry through competition.

The business model of Hedge Funds brings the logic of the shareholder regime to perfection. HFs have become the engine of a process where the search for profit as such – which is a normal aspiration in a market economy – is replaced by the absolute maximum profit as the driving force of activity.

2.2. Hedge Funds – the fastest growing sector of the financial markets

HFs are growing fast in terms of assets, activities and number. The assets under management of HFs have grown between 1990 and the second quarter of 2007 by 1,381% according to estimates from McKinsey (see chart 3). The assets of the HFs in 2007 amounted to 1.7 trillion USD. McKinsey also estimates that the leverage is three to four times the assets under management. In other words, HFs would have operated with about 6 trillion USD in 2007 (McKinsey 2007). In individual cases the leverage ratio may be much higher. For instance, the HF *Carlyle Capital*, which collapsed in 2008²² could operate with 22 billion USD, and only 670 million USD were covered by its own assets. This is a leverage of 1:32.²³

Chart 3



²⁰ At the time of the G8 2007 in Heiligendamm, there was a strike in the German Telekom, because a big HF had bought shares and required layoffs. Finally, the trade union could prevent job losses, but had to accept a reduction of salaries.

²¹ Der Standard, 11.10.2007

²² SPIEGEL ONLINE 13.03.2008

²³ Frankfurter Allgemeine Zeitung, 14.3.2008

The number of HFs has grown to 9.000 in 2006. However, 65% of the assets are concentrated in the hands of the 100 largest firms compared to 54% in 2003 (FSF 2007). In other words, there is a strong concentration. 40% of the assets of HFs originate in HNWI's (McKinsey 2007). This proportion has declined. In 1997 it was 61%. This trend is an indicator for the increasing importance of institutional investors.

HFs have considerable market shares in certain sectors of the financial markets (see table 1).

Table 1.

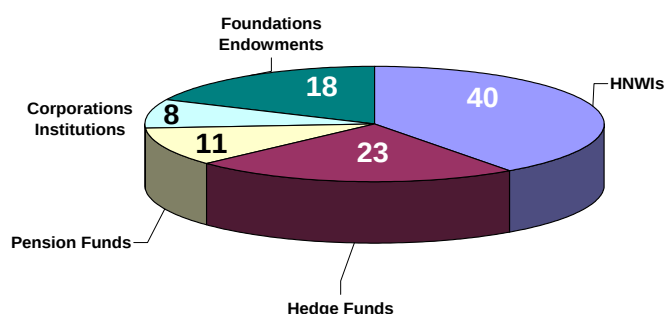
HFs share of trading (estimate)	%
Cash equities N.Y. & London SE	35
US Government bonds	30
High yield bonds	25
Credit derivatives (unstructured)	60
Structured credit derivatives	30
Emerging market bonds	45
Distressed debt	47
Leveraged loans	32

Source: McKinsey

Geographically, the lion's share of the assets comes from the US (63%), whereas Europe is represented with 24% and Asia with 8%. The US growth rate is 12%, while the assets of Asian and European funds grow much faster (40%).

Chart 4

Origin of Hedge Funds assets 2006 (in %)



Source: McKinsey 2007

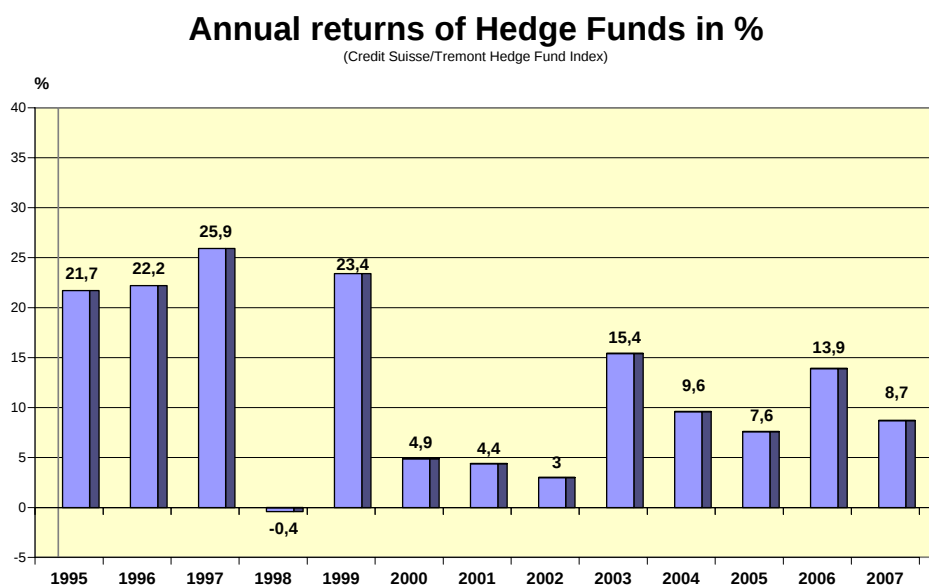
Source: McKinsey 2007

As for the returns of HFs: there is no really reliable data, given the opacity of the business. In any case: “A variety of hedge fund indexes show that they have outperformed world equity markets over the past ten years.” (McKinsey: 2007 p. 100) The Credit Suisse/Tremont Hedge Fund Index was 11.2 percent between 1996 and 2006 (ibid.), although the top performers exceed 20%, so called *alpha returns*, as they are called in the jargon of the community.

The volatility of the returns becomes obvious we look at the annual performance (see chart 5). There is a very clear correlation between boom/bubble on the one hand and crash on the other hand. The returns were very high – up to 25% - before the Asian crisis and fell dramatically with the crash. The same pattern can be seen in 2000 with the burst of the *New Economy* bubble. And again, in 2007, the beginning of the US sub prime crisis is visible, which will continue in the form of a drastic fall in 2008. It is not surprising that this is reflected in the cycle of bubble and crash, given the speculative character of HFs.

As another general trend we can see that the model has been adapted by many others after the excessive profits in the nineties. This leads to more competition and shrinking.

Chart 5



Source: McKinsey 2007

2.3. The role of Hedge Funds in the present crash

Hedge Funds are heavily involved in the present crash and suffered from dramatic losses. The IMF identifies the HFs in its Global Financial Stability Report (GFSR) from April 2008 as one of the main institutions responsible for the crisis: “There was a collective failure to appreciate the extent of leverage taken on by a wide range of institutions—banks, monoline insurers, government-sponsored entities, hedge funds—and the associated risks of a disorderly unwinding.” (IMF 2008:ix). Several HFs had to be closed. Some smaller funds were already shut down in 2007, such as Braddock Financial Corporation (300 million USD assets under management), United Capital

Asset Management (500 million), Caliber Global Investments (908 million), and Queen's Walk Investments (400 million assets under management). In the meantime Peloton, Sailfish and Focus Capital went bankrupt.

The case of Bear Stearns is much more spectacular. The Bank maintained three HFs, the High Grade Structured Credit Strategies Fund, the High Grade Structured Credit Strategies Enhanced Leverage Fund and the Asset-Backed Securities Fund. All three were strongly involved in deals with Collateral Debt Obligations (CDOs) in the US sub prime sector and were operating 20 billion USD.

The CDOs are complex derivatives. The principle is as follows: the sub prime papers are pooled; then the pool is divided into tranches; high risk CDOs with high returns take over the bulk of the usually expected risk; a second tranche is created with a rest of risk and a third tranche without risk and the lowest returns (Troost 2007). Just like a butcher who is making sausages of different quality - one with grease, guts, skin, bones, and another with grease and a better one with meat – they made *Triple A* products out of junk. The two HFs had problems when the crisis began. *Bear Stearns* tried to overcome them by obtaining a credit of 1,6 billion. However, the operation failed and *Bear Stearns*, the fifth biggest investment bank in the US, finally was de facto bankrupt in March 2008. The Fed consequently undertook a rescue action by making a credit over 30 billion USD available to *J.P. Morgan Chase & Co.*, to enable them to take over *Bear Stearns*.²⁴

The end of the crisis is not yet in sight. In the *Global Financial Stability Report* the IMF estimates losses of almost one trillion USD. The real economy will be hit not only in the US. It cannot be excluded that the HF business will collapse more or less completely during 2008.

The disaster with the HFs bears out those who have been critical of the HFs. These critics were not only non-orthodox academics, NGOs, trade unions and other civil society organisations but also several main stream institutions such as the *European Central Bank* which pointed at the stability risks of HFs. The ECB therefore suggested a credit register (ECB 2005).

HFs are not innocent victims of the crisis. They are part of the problem. The business model in itself has contributed to the crisis. In particular, the leverage and the use of structured products have proven to be factors of instability. The system of leverage has quite a resemblance to a Ponzi game and the derivatives/structured products lack transparency to an excessive extent. The contagion is globalised through liberalisation. The insecurity with regard to the further development of the crisis is also due to the fact that nobody knows where all the papers are.

The crisis has shown that the positive role as risk takers that advocates of HFs have attributed to the funds was an illusion. It is true that HFs have taken risks that other market participants did not want to take. But the risks did not disappear, nor were they distributed in way which made them less dangerous. On the contrary the risk were increased as a result of leverage and opaque instruments such as CDOs. Attributing a risk reducing role to the HFs is like assigning the position of fire prevention to a pyromaniac.

²⁴ NZZ Online 17 March 2008.

2.4. Hedge Funds and developing countries

There are some Hedge Funds which are located in emerging markets. 423 hedge funds can be classified as emerging market hedge funds according to the commercial database of *Hedge Fund Research* (Füss/Kaiser 2006). However, *emerging market hedge fund* means that the majority of its assets are invested in emerging markets, and does not automatically mean that they are based there, nor that the assets are coming from there. These 423 would be approx. 4,7% of all the 9.000 funds. They had 62.57 billion USD in assets under management in 2006. This corresponds to 8,6% for that year (ibid). The number has been increasing in the last years.

There will probably be no or extremely few HFs in *Low Income Countries (LICs)*. The Funds need an infrastructure of financial services for their operations. LICs cannot offer such an environment. Therefore the impact of HFs on LICs will always be indirect through their effects on the stability of the international finance system, through instigating capital flight by the respective elites, etc. (see below).

HFs operating in emerging markets transfer the specific risks of these players to the target countries. As Griffith-Jones reported, in 1998, Brazil was affected by the speculative operations of HFs who were trying to compensate losses from the Russian crisis in the same year. Also the crash of LTCM had effects on Brazil (Griffith-Jones:2007 p. 13/14) .

There is no information available about the involvement of these HFs in the crisis to date. However, the *Carlyle Group*, whose HFs, as mentioned above, crashed in March 2008, has investments in leveraged buyouts in India to the extent of over 1,3 billion USD through its subsidiaries *Carlyle Asia Growth Partners II* and *Carlyle Asia Growth Partners III* (Singh:2007). The future will show whether these investments are affected by the crash of the mother firm in the US.

Nevertheless, the crash experience could put a brake on the further development of the industry in the emerging markets. It might have a deterring effect. If HFs can destabilise the financial markets of the industrialised countries, it is obvious that these players are even more dangerous for the vulnerable economies of the South: "*A new source of financial vulnerability for developing countries lies in the rapid growth of hedge funds, and more broadly highly leveraged institutions*" (Griffith Jones:2007 p. 2).

The particular involvement of emerging markets in HFs practices is shown by the high proportion of emerging markets bonds (45%) and distressed debt (47%; see table 1). Of course these shares are distributed among several countries. However, if there is a certain concentration on individual countries, this leads to risk exposure for the respective economy.

A specific risk of HFs not only for emerging markets but for other developing countries derives from the reaction of HFs to the present crisis. Given that the traditional areas of business are drying up, they reorient their deals among others towards speculation with raw materials, oil and food. This leads to an increase in raw material prices. This particularly hits the oil importing countries and those who depend on raw material imports.

As for the increase in food prices, the German Ministry for Development writes: "*The international capital markets have, in their search for profitable and safe investments turned their attention to the agricultural markets. This leads to more volatility, in particular if highly speculative actors enter these markets.*" (BMZ 2008 p.3)

Independent of that specific effect, there are some repercussions of the crisis on developing countries which are only indirectly connected to HFs:

- first of all, developing countries will suffer from the crisis because global growth will decrease. Demand from the industrialised countries will be reduced;
- those developing countries having close economic relations with the US will in particular be hit (Eichengreen 2007);
- the exports of developing countries will become more expensive due to the depreciation of the US Dollar;
- the depreciation of the Dollar will also cause a devaluation of currency reserves for those countries which have accumulated Dollar reserves;
- the crisis also induces banks to place restrictions on lending towards developing countries;

To a certain extent, the negative effects might be offset by positive effects. For instance:

- imports will be cheaper. This is particularly positive with regard to the oil bill;
- this is also positive for the debt service of those countries carrying debts if interest rates in the US decrease.

Nevertheless, the insecure environment and volatility of the financial markets and the high risks of leveraged institutions and their speculative business models are basically negative for the developing world. Development needs a stable and predictable environment.

2.5. Is there nothing positive about Hedge Funds?

In the debate about HFs before the crash, the beneficiaries of HFs and their supporters have always argued that the funds have positive features and therefore require no regulation. The main arguments were:

- HFs would increase market liquidity,
- HFs would be innovative,
- HFs would take risks that others would not take, thus contributing to risk mitigation,
- HFs would increase efficiency.

In fact, market liquidity is increased. However, this is not a benefit in itself. There was already enough liquidity in the markets. There can be overliquidity, which is negative, because it distorts asset prices and leads to speculation. And in fact, the liquidity generated by the HFs has served nothing more than feeding the speculative bubble which has now burst.

HFs also were innovative. But they invented instruments such as the CDOs which proved to be fatal. Innovation as such is not in itself of value, either. The quality of an innovation determines whether or not it is beneficial. The type of innovation devel-

oped by the HFs is very similar to the innovative butcher which had the idea of putting sawdust in his sausages.

As to the risk mitigating role of HFs, we have seen under point 2.4., that the reverse is the case. Hedge Funds have increased risks and instability. They are one of the important factors leading to the present crash.

When talking about efficiency, there is a need to differentiate between efficiency on the micro level and efficiency on the macro level. Efficiency on the micro level, as understood by the economic mainstream, means nothing more than the ratio between investment and return. This is a very reductionist concept of efficiency. It is an uncomplicated one-factor concept which externalises other factors of wealth creation, for instance labour. In its reductionist form there was in fact HFs efficiency, i.e. maximising profits for the shareholders. Efficiency of this type is none other than what we call *shareholder regime* in a critical perspective, but is presented in the form of a “think-positive- envelope.”

On the macro level, efficiency means the optimal allocation of resources. In this case this would mean that investments are going to where they are most needed. If the HFs make the rich richer and institutional investors stronger, then HFs contribute to macroeconomic efficiency. However, the reality of the crash makes it difficult to maintain the illusion of HFs contributing to macroeconomic efficiency.

To conclude: the positive sides of the HFs can only be detected for a small group of beneficiaries, the shareholders and the fund management. HFs generate no positive but only heavy negative effects for the economy as a whole.

2.6. Who needs Hedge Funds?

There have been several proposals for regulating HFs. They are mainly motivated by concerns over the stability risks. If we leave the proposal of voluntary self-regulation aside, which results in the fox stopping himself from stealing chickens, the majority of proposals concern transparency, such as the proposal of the German Government at the G8 or the ECB's idea of a credit register.

Another category of proposals envisages reforms in corporate governance, ranging from changing incentives for fund managers²⁵.

Other proposals target leverage, by increasing the capital requirements or introducing a ceiling on leverage (DGB 2007).

In a recent paper, Attac Germany has suggested that banks should not be allowed to trade derivatives over the counter. Only standardized products traded at the stock exchange and thus under supervision should be allowed (Lipke 2003).

Griffith-Jones recalls the situation in Malaysia during the Asian crisis, where capital controls could prevent major damage (Griffith-Jones 2007).

Of course, increasing capital requirements, prohibiting OTC trade with derivatives and capital controls would be useful measures to curb the worst side effects of HFs. Properly applied, they would take away the peculiarity of HFs and neutralize their comparative advantage for investors. They would turn HFs into relatively normal investment funds. Of course, this is why the present beneficiaries of HFs will move

²⁵ In some cases, incentives to managers have already been established in order to prevent them from taking excessive risks.

heaven and earth to prevent such reforms. The further development of the crisis will determine whether political decision makers will have the courage to go that far.

Apart from that, the question of who needs HFs should be raised. As we have seen above, HFs only have a negative effect on the economy and benefit only a very small group of shareholders and fund managers. It is the role of civil society to go beyond what is proposed by governments. As mentioned above, HFs were prohibited in Germany until 2004 - for good reasons. There is no reasonable argument why civil society should not introduce the proposal of shutting down Hedge Funds in the current reform debate.

3. Private Equity Funds - Honey bees or locusts?

As already indicated above, Private Equity Funds are a subclass of institutional investors. Therefore, what has been said under point 1 also applies for them. A synonym for PEF is *Leveraged Buy Out*.²⁶ This expression describes the core idea of the business model.

PEFs emerged in the 1960s (Böttger 2006), but just as with Hedge Funds, they only became a relevant factor when the financial markets were liberalised and deregulated. Today, not only players specialising in the private equity business but also global players on the financial markets such as banks (among others Morgan Stanley, Citigroup, Deutsche Bank, Credit Suisse) have entered the private equity market.

3.1. The business model of Private Equity Funds

The business model of PEFs has many similarities with HFs:

- in order to avoid paying taxes, their preferred legal locations are in OFCs, while the management is located in metropolitan areas,
- they normally have minimum requirements for investors with regard to the assets to be invested,
- they promise the investors a *hurdle rate* as minimum performance,
- they operate with leverage in order to carry out huge deals beyond the value of their own assets and thus to boost their profits.

The repayment liability for loans is later transferred to the acquired company. It has to provide the debt service and in case of a default, the company represents a certain security. In other words, the risk for the investor is smaller than in the case of HFs.

However, the decisive difference to HFs is that PEFs don't invest into portfolio speculation but in the real economy.²⁷ They buy a company for the purpose of reselling it at a profit three to six years later. The fund is then dissolved.

The companies which are bought are either not listed publicly, or if they are, they are removed from public listing. The reason for this is that publicly listed companies are subject to more transparency and regulation. Transparency and regulation are considered to be a negative externality by the PEF industry.

Once a PEF has gained control over a company²⁸, it is subject to restructuring in what the PEFs call "*active management*". Typical restructuring measures are:

- reduction in the workforce through the laying off of workers and other personnel,
- increased work time for the remaining workforce,
- cancellation of social benefits,

²⁶ The definition of private equity as leveraged buy out is also the mainstream definition (see McKinsey 2007). It excludes venture and mezzanine capital, which sometimes are also considered under private equity.

²⁷ Whereas vice-versa, HFs sometimes invest in the real economy and try to make their profits through shareholder activism.

²⁸ It is necessary to gain complete control over the company to restructure it. PEFs therefore tend to acquire not only minority shares but the whole company, or at least a proportion which is high enough to obtain control over management decisions.

- the sale of components which are not profitable (outsourcing),
- the sale of components that are particularly profitable (filleting),
- reorganisation of the remaining parts of the company and of the management,
- implementation of new marketing strategies.

Additionally, PEFs have become a major factor in mergers and acquisitions (M&A). Their share in M&As rose from 4% to 28% in the US and from 2% to 17% in Europe (McKinsey).

The situation is ambiguous as far as the handling of technology is concerned. PEFs present themselves as modernizers in their official PR.. There are in fact cases where investments have taken place. However, as a general rule, investment into new technologies only occurs if it is profitable in the short time schedule of the investment, i.e. if it can be expected to make the resale more profitable. But there also exist cases where even investment into the maintenance of the existing technological level is not made. In such cases the PR tries to hide it and/or cosmetic measures are taken, such as repainting old machines, what insiders call “embellishing the bride” (Hennemann 2007).

An additional source of profit performance are also extra dividends.

Schematically the profit performance of PEFs is composed of the following sources:²⁹

- a. leverage
- b. transferring loans to the acquired company
- c. restructuring
- d. extra dividends
- e. resale

3.2. Quantitatively rather small, but

It seems at a first glance as if PEFs would be a marginal player when looking at the figures. All in all, the assets under PEF management amount to 700 billion USD, and this is half of that of Hedge funds and only 5% of the value of companies listed by the US stock market. The annual growth rate is 14%. This is less than the growth rate of Hedge Funds, which was 20% - before the crisis. However, the influence of PEFs goes far beyond their statistical importance, as we shall see below in chapter 3.3.

Where does the assets money come from? The largest share with 37% comes from other PEFs. The second place is held by pension funds - corporate and public - representing together 33% (see chart 6). As with the fund of funds assets, a similar proportion of pension funds will be represented, the pension funds are de facto the biggest investors in PEFs.

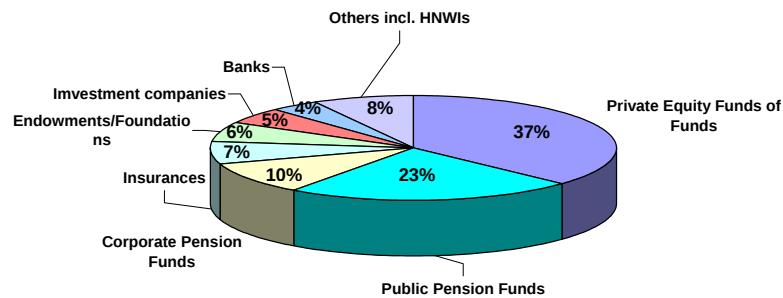
Pension Funds are more risk adverse than other institutional investors. The income and living standards of their clients are dependent on them. This is also why

²⁹ There are also some different models such as “Vulture Funds”, which focus on companies in financial difficulties which first are stripped their assets in order to achieve returns and then go bankrupt or are sold to another “Vulture Fund” which repeats the same procedure on an even lower level.

supervision and regulation of Pension Funds is stricter. As a consequence, the systemic risks are less than for Hedge Funds, although this does not mean that they do not exist.

Chart 6

Origin of PEFs assets 2005 (in %)

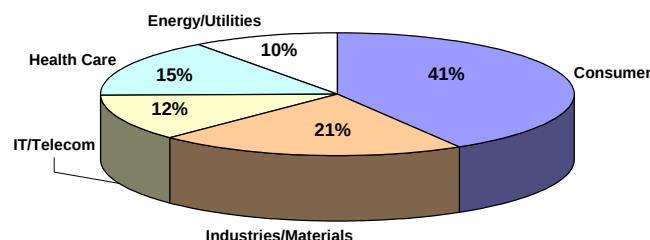


Source: McKinsey 2007

Looking at the target sectors of PEFs investment, the consumer product sector is by far the biggest (see chart 7). The IT/Telecom sector's share has shrunk by half since 2000 as a result of the bursting of the *New Economy* bubble. On the other hand, the health care sector has dramatically increased. Whereas in 2000, its share was only 2% of the current amount of 15%, i.e. 7,5 times higher than six years ago (McKinsey 2007).

Chart 7

Target Branches of PEFs 2006 (in %)



Source: McKinsey 2007

As for the returns of PEFs, McKinsey qualifies them as not “particularly impressive”. Not only HFs but also real estate³⁰ and US equities had shown a better performance. Nevertheless, the top quartile of PEFs has reached profits of 29% in the US and in Europe. The second quartile reached 12%, which is still approximately double of what can be reached in the real economy, and the performance of the third quartile was still at 5% (McKinsey 2007).

It seems that PEFs will be heavily hit by the financial crisis. The drying up of the credit markets will have a strong impact not only on the Funds themselves, but also on the companies which have to carry the debt service of the leverage operations. As interest rates go up, their debt burden will increase. During 2007 the value of announced transactions already fell from 131 billion USD in June to 19 billion in August 2007, according to press reports.³¹

3.3. The effects of PEFs

As mentioned above, the importance of PEFs lies not so much in their quantitative dimension but in the qualitative impact they have on real economy. There are two main effects which the mainstream of the finance community particularly praises:

- the opening up of new areas of company funding,
- improvement of efficiency.

The McKinsey study has put it in almost lyric words: “*The changes it has spurred in corporate governance have breathed new life into private ownership.*”(McKinsey 2007: p.127).

In fact, the business model of PEFs is a catalyst for a basic shift in financing of unlisted companies: whereas traditionally these companies financed themselves through their house bank, today they do it increasingly on the financial market. But this has far reaching consequences. The traditional relationship between a bank and a company formed a kind of symbiosis of interests. Not only did the bank know its client well, it also had an interest in the long term stability of its client, in order to get its loans serviced. Financing through the financial markets have replaced this relationship by the interests of shareholders, which have no connection with what the enterprise is doing. It is the naked interest of short-term maximum profit which is channelled into real economy through this new type of financing.

Additionally, funding through the financial markets makes enterprises much more dependent on the trends on financial markets. Long term interests such as technological innovation and long term competitiveness are considered less important.

On the other side, the leverage constitutes an element of financial instability. Although it is not yet known whether, and if yes, how far PEFs are involved in the financial crisis, it is obvious that the drying up of credits will hit them. The rising interest rates will furthermore increase the burden of debt service for the respective enterprises.

As for the improvement of efficiency and what is called *spurring corporate governance*, this is correct as long as it is not implemented at the cost of long-term interests of the enterprise and at the costs of labour and social concerns. Respective

³⁰ Of course the burst of the real estate bubble in 2007 will have changed this ranking in the meantime.

³¹ International Herald Tribune, August 29, 2007.

studies, such as a study by PriceWaterhouseCooper and EVCA (European Private Equity and Venture Capital Association³² – the European lobby organisation of the PEF industry) or from McKinsey all conclude that the returns of most of the enterprises which undergo restructuring by PEFs have increased. However, these studies are based on information provided by the management and do not reflect independent research, or an analysis of the sources of these improvements.

PEFs are particularly problematic in sectors which are considered as part of public goods, such as health or in environmentally important infrastructure sectors, such as energy or transport. The dramatic increase of PEFs investment in this area raises serious concerns. It means that the shareholder regime is penetrating an area where basic human needs and services of general interest are at stake. They should not be subject to commercialization in general and the shareholder regime in particular.

In spite of some individual examples (Blome-Drees/Rang 2005) where enterprises were saved from downturn or even collapse and where there were no negative effects on labour and social concerns, these cases cannot be generalised. A series of case studies, carried out by the German Hans Böckler Foundation (Kamp/Krieger 2005), empirically confirms, what may be expected if one looks at the logic of PEFs: labour interests, employment, social concerns or other stakeholder interests such as consumer protection or environment are of no interest to the protagonists of the model, and, in consequence, are bearing the burden of the profit requirements of the investors. Typical of that attitude is the statement of European Commissioner McCreevy: *“Hedge funds and private equity are good for the market. They have given greater liquidity, they have added shareholder value and they have helped the rationalisation and innovation of companies”* - the partial view of the HF and PEF lobby, and the ruthless ignorance towards anything beyond the interest of maximum profit.

3.4. PEFs and development

Just like Hedge Funds, PEFs are also beginning to be active in developing countries, in particular in emerging markets. The data available are very scarce. 6% of all PEFs investment in 2005 was outside industrialised countries, according to *International Financial Services*. This would correspond to 8,1 billion USD.³³

UNCTAD reports that PEFs are particularly active in mergers and acquisitions. They were involved in 889 merger and acquisition deals in 2006, some 18 percent of the global total and worth a record 158 billion dollars. According to an UNCTAD list of 50 major mergers and acquisitions in which PEFs are involved, India and Turkey are, however, the only cases which are mentioned as target countries. In four cases, the United Arab Emirates and Saudi Arabia, Egypt (Special purpose finance company Naguib Sawiris. Target country: Italy, Weather Investments Srl.), and China were listed as the countries of origin of a M&A (UNCTAD 2007 p.216). As a pattern, we can see that the Petro-Dollar economies are a main source of PEFs in developing countries.

A specific case is China. The country is now using a part of its huge foreign currency reserves to enter into financial markets operations. A special state-owned company has been established for this purpose. Thus China has bought 3 billion USD shares

³² www.evca.com/images/attachments/tmpl_9_art_37_att_333.pdf

³³ www.ifsl.org.uk/uploads/CBS_Private_Equity_2006.pdf

of the US based PEF *Blackstone*, the biggest HF in the world, which will give the country a 9% stake (Singh 2007). A peculiar species of Private Public Partnership.

India is both the target of PEFs and the origin of an Indian PEF industry. The country is at the top for PEF investment in Asia (see table 2) The investments of foreign PEFs in the country have increased from 1,1 billion USD in 2004 to more than 10,8 billion in August 2007 (Venture Intelligence India 2007).³⁴ This an increase of more than 1,000%. Among the investors are major players in the business such as Blackstone, Citi Group, KKR, TEMASEK and Carlyle (Singh 2007). However, 80% of the capital was not used for buyouts but for acquiring minority stakes without taking over the management (Singh 2007). At this stage, the main motive of the PEFs is obviously the participation in the high growth rates of the Indian economy.

The target sectors in India are infrastructure, real estate, financial services and media (Singh 2007).

Table 2

PEF investments in Asian Developing countries 2006

	N° of deals	N° of funds	Invested (bn. USD)
India	143	126	7.4*
China	145	129	1.7
Vietnam	5	5	0.85
Thailand	4	4	0.72
Indonesia	2	2	-
Pakistan	1	1	-
Sri Lanka	1	1	-
TOTAL	301	268	10.67

Sources: Thomson Financial Asia Pacific Private Equity Markets³⁵ / *Venture Intelligence

As for home grown PEFs Singh lists 10 funds with total assets of 3,12 billion USD. Like the PEFs in the industrial countries, the Indian PEFs go offshore, mainly to Mauritius, in order to avoid taxation and supervision.

Another interesting case with PEF involvement in a developing country is the Chad-Cameroon pipeline project. Part of the consortium of companies carrying out the project is the Malaysian state owned PEF *Petronas* with 35% of the shares (UNCTAD 2007 p.151). The one thousand km pipeline cuts through ancient tropical rainforest and through the territory of indigenous communities which depend on the forest. The negative impact of the pipeline on their social welfare has been considerable. However, although *Petronas* is involved, the problems cannot be reduced to its role as PEF.

Nevertheless, UNCTAD, also concludes that PEFs in developing countries are as questionable as a player as in the industrialised countries: *"Investments by private equity firms are often more akin to portfolio investment than to FDI, in that they tend to have relatively short time horizons. This has raised some concerns regarding the impact of such investments, in particular as regards the dismantling of the acquired companies and worker layoffs."* (UNCTAD 2007 p. 17).

³⁴ www.ventureintelligence.in

³⁵ www.thomson.com/solutions/financial/privateequity

3.5. Another financing of companies is possible

There are several proposals to regulate PEFs in order to mitigate their negative impact on long term interests, technological innovation, labour, social concerns and development, while maintaining the function of company funding and improving efficiency at the micro level. The main proposals are:

- increase in capital requirements, in order to limit leverage and the systemic risks linked to it,
- transparency,
- licensing, which prevents offshore companies from operating,
- changes in governance structures of PEFs such as double or triple voting rights for long term shares,
- prohibition of extra dividends,
- worker participation.

The implementation of these proposals would in fact mean that PEFs lose their problematic character and would turn into useful vehicles for company financing.

On the other hand, it is questionable whether the model would be supported by investors, since it would have lost its attraction for them. Therefore, parallel to regulating PEFs, alternatives for company funding should be developed. In particular the “traditional” type of finance through bank loans should be restored, by creating incentives for banks to provide capital, including venture capital.

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