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ONEWORLD

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Advance praise for *One Step Ahead*

"Hedge funds are being punished, and private equity is getting abuse, for things they did not do – merely because the politicians do not understand them. *One Step Ahead* explains in simple language what hedge funds and private equity are all about – and why they should be left alone to manage wealth and create wider prosperity."

Eamonn Butler – Director, Adam Smith Institute

"This is a book for people looking for deep understanding and careful analysis, rather than empty sloganeering – and yet it will be immediately accessible to the average reader, which is a remarkable accomplishment."

Robert VerBruggen – *National Review*

"Bringing shadow banking out of the shadows, *One Step Ahead* sheds light on alternative investment funds and their role in the economy. Spangler, who understands the nuts and bolts of hedge funds and private equity in the US and European contexts, gives the general public knowledge, which is power, to grasp their role in our economic future. The lines that distinguish one alternative investment fund from another are anything but bright. *One Step Ahead* identifies some growing trends among hedge funds and private equity funds and the regulatory hurdles ahead for such funds due to new legislation, and outlines why we should care."

Noreen Clancy – RAND Corporation

"Like a series of exceptional *New Yorker* articles, *One Step Ahead* provides a detailed and engaging insider's view of the seemingly-secret world of alternatives from every perspective - birth to death, rumor and myth to simple truths, and whys and wherefores. Practitioners and investors alike should get their hands on this book ASAP."

Karyn Polak – Chief Counsel, PNC Financial Services

"*One Step Ahead* is an excellent insight into the structure and workings of the 'pointy end of capitalism', the hedge fund and private equity industry. From a true insider, *One Step Ahead* introduces us to the main players, the rules under which they play, and the politics of how those rules come about. Written in a very readable and accessible style, this book should be read by anyone wanting to learn more about this important and politically contentious sector."

Professor Julia Black – London School of Economics

"Timothy Spangler, with *One Step Ahead*, has presented a long-overdue synthesis of the economic, legal and political issues surrounding the world of hedge funds and private equity. Spangler fills a gap in the literature and provides the right balance of technical detail and high-altitude perspective needed by investors, lawyers, and policy-makers looking for the big picture in this field."

Thomas Grant – University of Cambridge

"A lucid, inside account of how hedge and private equity funds work and their economic and social utility, with wider reflections upon the context of the political economy. A demystifying read for the intelligent layman."

Dr. Iris H. Chiu – University College London

"When so much of the debate around our financial system is clouded in misunderstanding, it is refreshing to read such an engaging and accessible account as *One Step Ahead*. By setting out the facts clearly and cleanly, Timothy Spangler goes beyond the jargon and the headlines to give readers an accurate portrayal of the role of private equity and hedge funds in modern capitalism."

Mark Florman – Chief Executive Officer, British Private Equity and Venture Capital Association

"*One Step Ahead* expertly combines an insider's understanding of behind-closed-doors industry dynamics with an everyman's ability to tell the story in a way that a Main Street reader will understand and appreciate. By focusing on the 'pointy end' of modern capitalism, Spangler tells a tale that is relevant and educational to us all."

Robert Diamond – Fernbrook Partners

"*One Step Ahead* opens up the opaque world of hedge and private equity funds with precision in an accessible way for the non-specialist. Complex technical issues are conveyed concisely but never over-simplified ... A fascinating read and some surprising, sometimes shocking, conclusions."

Giles Adu – Managing Partner, Brook Street Partners

"Finally a book that sheds a knowledgeable light on the private equity and hedge fund worlds. Long demonized by the media, Timothy Spangler has humanized these often secretive industry sectors all the while revealing just how essential they are for nursing sick companies back to health and bringing rationality to markets."

John Tamny – Forbes Opinions and RealClearMarkets.com

"The ravages of the financial crisis and the bruising Presidential campaign in 2012 for which it served as backdrop, have catapulted the alternative investments industry into the public consciousness. Spangler provides a comprehensive account of the issues surrounding the industry, invaluable to anyone wanting to cut through the political point scoring and amorphous resentment that have characterized the debate to date."

Solomon Teague – Financial Journalist

"*One Step Ahead* gives a clear, practical and realistic insight into the private equity industry today, in contrast to the pre-conceptions, clichés and 'sound-bites' about private equity that have been sensationalized in the popular press ... this book provides an important voice in seeking to balance the political debate where the industry itself has struggled to do so."

Aristide Stavropoulos – Ridgeway Capital LLP

"Timothy Spangler has written a masterful and comprehensive overview of hedge funds and private equity pre- and post-crisis. Very well written and accessible, *One Step Ahead* is required reading for anyone wanting to understand the challenges and limitations of regulation and enforcement."

Alistair Macnaughton – Chief Legal Officer, Mulvaney Capital Management Limited

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For my wife, who only after a few years of marriage realized the important difference between a hedge fund lawyer and a hedge fund manager, and for any young women of marriageable age today who consider this distinction significant.

ONE STEP AHEAD

Prologue

As a result of the global financial crisis, much ill feeling remains toward Wall Street, the investment banks and those individuals who profit from short-term movements in the financial markets. As the crisis drags on into 2013, more questions are being raised about how the modern financial system actually works. Identifying "who does what" when it comes to complex derivative securities or the takeover of well-established, brand name companies by faceless financiers seems much more difficult today than a generation ago.

Over the last decade, private equity and hedge funds have entered the mainstream public consciousness after many years of profitably operating in the arcane shadows of the economy. Although originally developed in the United States, these funds quickly expanded across the Atlantic to establish a base of operation in London. As they became more and more successful, their techniques, tools and structures rapidly spread to financial centers around the world.

The financial meltdown that commenced in earnest during the autumn of 2008 soon led many observers, commentators and regulators to question more closely what it is that private equity and hedge funds actually do. Many of the concerns that were identified, though, require a deeper understanding of the structure and operation of these funds in order to properly evaluate them. Without this broader context, effective criticism simply isn't possible.

In a single weekend in October 2011, however, protesters inspired by the Occupy Wall Street movement held demonstrations in over 900 cities around the world. Their goal was to draw attention to corporate greed and massive cuts in government spending. Images of these protests filled television screens and social media websites for the weeks that followed.

Unfortunately, the lingering financial crisis is about more than just greed. This is why it has been so difficult to understand precisely what is broken and how it can actually be fixed. But talking about greed and making signs about greed and chanting slogans about greed is much easier and much more compelling than actually trying to understand the complex web of linkages between monetary policy and asset values, or how best to oversee the diverse operations of cross-border financial conglomerates, let alone how nimble, entrepreneurial financial firms such as private equity and hedge funds are able to earn the eye-watering profits that they do.

Marching behind a banner that says, "We demand the forgiveness of all debts," has a certain rhetorical conciseness, even if it is an utterly impossible and unattainable goal.

After two years of Tea Party protests in the United States that tapped into popular anger at excessive government borrowing and spending that appeared fatally out of control, the Occupy movement demonstrated that popular anger could also be marshalled by the Left to attack Wall Street and the global financial infrastructure, even if only for a limited period of time.

While the thrust of the Occupy movement was to attempt a critique of the economic superstructure within which we live, the focus of the earlier Tea Party movement was to voice concern over a government that has grown morbidly obese and ineffective on high taxes and incompetent bureaucrats unable to adequately address the mounting problems that the country faces.

These two points are not mutually exclusive.

Americans and Britons were notably quiet in the initial months after the financial crisis first made itself known in autumn 2008.

Despite the near collapse of many parts of the international financial system, and unprecedented levels of governmental intervention into Western economies, for many the events on Wall Street and in the City of London were far removed from their day-to-day lives. It took until 2010 for the Tea Party to gain sufficient momentum in the United States to break through into the public consciousness and until 2011 for the Occupy movement to enter the public stage.

Millions of people are angry, and many millions more are simply frustrated. At the beginning of 2012, it was estimated that over 20 percent of US residential mortgages were under water and almost 15 percent of Americans used food stamp benefits. Statistics in Britain and other European countries were equally bleak. As their attentions turns to out-of-touch governments and moneyed elite that they find hard to understand, Americans and Britons and millions of others are beginning to ask questions about a new generation of independent money managers who have established themselves as key players in the financial markets over the past four decades.

Walk down Fifth Avenue or Knightsbridge in 2013 and it is eminently clear that some people, at least, are still doing very well despite the economic upheaval. As a result, the focus on private equity and hedge funds continues to intensify. Unfortunately, many people still lack a deeper and more nuanced understanding of what these funds really do, and why.

A general public that no longer trusts business and finance will have tremendous difficulties relating to the sponsors and managers of private equity and hedge funds. These individuals operate in niche areas of finance that intersect with traditional investment banking and commercial banking firms, but their mandates differ significantly from stockbrokers, securities underwriters, mergers and acquisition (M&A) advisers and mortgage lenders.

The role of investment advisers and fund managers has been an established part of the world of finance for centuries. In that regard, private equity and hedge funds are clearly not unprecedented. They are not a recent phenomenon. Those with money have long recognized that the fact they amassed significant sums in the past is no guarantee that they have the knowledge and acumen to invest it wisely and effectively in the future. As a result, talented individuals have long established themselves as trusted advisers who can assist in selecting the best use for these pools of capital which can provide for lucrative investment returns while at the same time seeking to maintain some level of security for the capital.

In fact, since the end of World War II, retail investment funds have replaced direct stock market investments as the most important way in which "Mom and Pop" investors access the securities markets. Known as "mutual funds" in the United States, "unit trusts" in the United Kingdom and "UCITS funds" in Europe, these retail funds now comprise an important part of many families' retirement savings.

In the simplest terms, private equity and hedge funds can be seen as different species of this same genus of "investment funds." Unlike retail funds, however, these funds are limited by law to sophisticated, non-retail investors. Uncle Edgar in Topeka and Aunt Edna in Balham are prohibited by their respective governments from putting their savings in these vehicles because the risk is deemed to be too high. These funds are, therefore, strictly off limits.

The sustained success of private equity and hedge funds in the last two decades, however, has led to more and more coverage of their investment activities in the mainstream press. As a result, more and more questions are now being asked about what they do, how they do it and why they have been largely free from direct regulation in the past.

Despite the passage of five years, we are still coming to terms with the events of 2008, and few consensuses exist on either their causes or their long-term effects. Given the increased prominence of private equity and hedge funds recently, it is wholly unsurprising that critics are now turning their attention to these "alternative"

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investment funds. Too often, however, the drive to further regulate these funds and limit their potential scope of operation is occurring in a vacuum devoid of detailed knowledge of their structure and evolution.

The first thing that strikes you now when you re-read the "Declaration" issued in autumn 2011 by the Occupy protestors assembled in Zuccotti Park in downtown Manhattan is how little of it actually relates to Wall Street. Many of the "demands" inserted into the manifesto drafted by the various grassroots organizations behind the protests have no relation to how Wall Street functions, or to the issues that have arisen since the Credit Crunch led America (and much of the developed world) into this Great Recession.

Following the age-old agitprop dictum that no good popular uprising should go to waste, it seems that a variety of other concerns, such as student loans, public employee pensions, animal rights and genetically modified food, were the principal concerns of many well-intentioned Occupiers. The complexities and intricacies of Wall Street and the City of London were largely ignored, except for a few cursory statements about bank bailouts and excessive compensation that were stapled on to their wish list.

The initial choice of venue – the financial district in Manhattan – gave the protestors a chance to air their long-standing grievances in a location imbued with deep significance. But frustratingly little of what was said, sung, chanted and painted on signs was actually directed at the way the global financial systems currently operate and how these practices could be improved. Few men and women who work on Wall Street or in the City of London would make the claim that modern financial markets have achieved some variant of divine perfection. These markets exist as a result of human endeavors and, as a result, they are subject to human frailties and flaws. There is always room for improvements.

The possibility that a generation of students and young people would remember for the rest of their lives the personal misery and frustration that has arisen in the last five years due to the near-collapse of our financial markets is actually very encouraging. As citizens and savers, we each have a responsibility to ourselves, our families and our country to have an opinion on the current state of our financial system and its regulation – even when the details of credit default swaps and high yield bonds lead to fits of sudden-onset narcolepsy!

Ultimately, though, an attempt at a direct and informed critique of the operation of the global financial system generally, and the role of private equity and hedge funds specifically, was frustratingly absent from the Occupy demonstrations.

The process of connecting savers with borrowers, and providers of capital with users of capital, requires intermediation. This need for intermediares creates a need for savings banks, stock brokers, brokerage firms, mutual funds and investment banks. Otherwise, it would be impossible to put Uncle Edgar's or Aunt Edna's pension contributions into the hands of the corporate treasurers of either Apple or Facebook, or the public coffers of various local, state and federal agencies who fund their operations with regular bond issuances.

Without such intermediaries, Uncle Edgar's or Aunt Edna's money would remain in an old coffee tin, where it would slowly lose its buying power when faced with the steady erosion of inflation. Simple laws of financial thermodynamics are at work all around us. Money at rest loses value over time. Money in motion provides the possibility of gains in excess of inflation, but also the risk of potential losses.

What we call "Wall Street" is a significant component of this intermediation infrastructure. Unless we move away from a monetized economy, and opt in favor of bartering on a scale never seen before, then the intermediaries must remain. The question then becomes what to do with these intermediaries, and the risks they pose to the rest of us.

The financial markets require regulation. Thousands of government employees around the world have as their direct responsibility the policing of banks, stockbrokers, hedge fund managers and pension trustees in their countries. The adoption in the United States of the Dodd-Frank Wall Street Reform and Consumer Protection Act (known as "Dodd-Frank") in 2010 and the ongoing restructuring of the financial regulatory regime in the United Kingdom demonstrate the belief that more needed to be done to keep regulation up to date in a rapidly evolving industry. Today, however, it remains unclear what the net effect of these numerous changes and "improvements" will actually be.

There will always be valid criticism that can be made about any industry, and Wall Street is certainly no exception. To the extent that the demonstrators in Zuccotti Park would have coalesced around a few convincing, compelling themes directly relevant to improving the financial infrastructure and ensuring that Wall Street is successful at spurring economic growth for the United States and its citizens (as well as in other developed and developing countries around the world), then they could very well have had a meaningful and lasting impact.

Since the Occupiers' demands remained frustratingly vague and ambiguous, distracted by an amorphous assault on rhetorical bogeymen and unable to propose clear and specific criticisms, then it was always highly unlikely that they would have anything like the impact that they desired and deserved.

Just "wanting change" is never enough.

The Occupy movement, however, was simply the most public display of concern and hatred that remains widespread to this day.

For example, in the autumn of 2011, a group of students at Yale University turned up at a recruitment event for the leading Wall Street investment bank, Morgan Stanley, which was being held near their campus. They were not dressed in blue power suits, tastefully complemented by a Hermes tie or a single string of

Mikimoto pearls. Instead, their purpose was to protest alleged Wall Street improprieties, and to encourage their fellow students to seek employment opportunities elsewhere. Despite the protesters' sincere and heartfelt pleas, the eager job applicants who assembled in New Haven that evening were simply following in the footsteps of countless prior Yale alumni who did exceedingly well on Wall Street, including, among others, Stephen Schwarzman, the founder of private equity titan Blackstone Group.

Emotions were so high at this time that some critics even went so far as to compare these recruitment events, which brought leading investment banks and financial firms to leading universities, to on-campus recruitment during the Vietnam War by the American military, in the form of Reserve Officers' Training Corps programs. The willingness to make such comparisons demonstrates how dramatically perceptions of the financial industry have changed since the global financial crisis began. Indifference and ignorance has for many been replaced by suspicion and anger. Around the same time, at Stanford University, an online campaign entitled "Stop the Brain Drain" sought to convince students that they should say no to the "dark side" of lucrative careers in high finance.

If Wall Street (and the private equity and hedge funds that have evolved in recent years) in fact depends on human capital as much as financial capital, as many of its champions have claimed over the years, then a lack of the best and brightest young men and women could eventually suck the oxygen out of the financial markets.

But where else would these talented, numerate and highly competitive graduates actually go?

It is easy to talk about the contest between "Wall Street" and "Main Street." It is a simple analogy and like most simple analogies, it can be very compelling.

When we witness a catastrophic event, such as the collapse of Lehman Brothers in September 2008 at the virtual epicenter of the global financial crisis, there is a deep-seated instinct to see those events as occurring in a completely different system of rules, concepts and language than what applies in your own neighborhood to a family desperately trying to refinance their home or a small business owner attempting to fund expansion at a time when his or her competitors are gobbling up market share.

But they are related in an intricate and insoluble way.

It is an oversimplification to say that Wall Street must exist for the purpose of serving Main Street. The problems that Main Street faces could be solved locally, without recourse to the financial markets that Wall Street and other financial centers orchestrate. Investors, savers, borrowers and issuers turn to these financial centers because they are in search of returns that are higher, or financings that are less expensive, than they can obtain in their own local communities.

Operating as a middleman, investment banks earn lucrative profits by matchmaking investors with potential investments. As more money is funnelled into the financial markets, there are more opportunities to trade in these investments and earn further profits based on which way the market moves over the short, medium and long term. Private equity and hedge funds are formed to identify and profit from precisely these opportunities.

After the early, and most spectacular, failures produced by the global financial crisis began to recede in our memories, the public conversation eventually returned to the concept of "fairness." In particular, more and more of the debate seemed to focus on a perceived lack of fairness in the context of excessive pay being earned by those operating at the highest rung of the financial services industries. Politicians on the Left, for example, have never been especially reluctant to play the fairness card when in search of further tax revenue, and the tax increase brokered in the closing days of 2012 between President Barack Obama and the US Congress was driven primarily by this desire for a "fairer" allocation of tax burden.

The great linguistic contribution of the Occupy movement – and perhaps its only lasting contribution – was mainstreaming the propaganda terms "the 1 percent" and "the 99 percent." On both sides of the Atlantic, as economies today remain fragile and unemployment stubbornly high, identifying with the 99 percent has resonated with many earners and savers who are having difficulty navigating the new financial landscape.

Eyes are increasingly turning to the so-called 1 percent. What is the proper role of the ultra-wealthy in addressing these issues? What should we expect from the private equity and hedge fund professionals who earn large sums of money from their investment acumen?

Interestingly, simply being wealthy does not appear to be enough to earn someone the negative sentiment that is directed at the 1 percent by the Occupiers and their sympathizers. It is curious how the bright lights of media coverage that follow around a lottery winner do not invoke the vitriol and judgmental language that a large Wall Street bonus does. This is particularly true if one gives any thought to the shockingly low payout rates of lotteries and how they disproportionately prey on the wallets of the working poor.

Is it right that money won by sheer luck from gambling should be considered morally superior to money that was earned through work? What is it about the manner in which the 1 percent are commonly believed to have acquired their fortune that is giving these critics so much concern?

It is increasingly difficult to find someone who is agnostic about private equity and hedge funds.

Many in the financial industry champion these investment vehicles as a means to deliver absolute returns, regardless of which way the market is moving on any given day, while providing other market participants with much needed liquidity.

Critics, however, have become louder and louder in recent years. A number of hedge fund blow-ups have raised concerns over the consequences of speculation on the "real economy." Names of now-defunct firms such as Long-Term Capital Management and Amaranth Advisors have become bywords for the possible

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