

- 1 **hot issues**
- 2 **securities lingo brain teaser**

1 hot issues

Hedge Funds – What Are They?

Hedge Funds are an aggressively managed portfolio of investments that use several investment strategies such as leverage, long, short and derivative positions in both domestic and international markets with the goal of generating high returns.

Legally, hedge funds are most often set up as private investment partnerships that are open to a limited number of investors and require a very large initial minimum investment. Investments in hedge funds can be illiquid as they often require investors keep their money in the fund for a minimum period of at least one year.

US mutual funds must be diversified, and are prohibited from holding more than a 10% stake in any one company or investing more than 5% of their total assets in any one security. The same rules do not apply to hedge funds.

For the most part, hedge funds (unlike mutual funds) are unregulated because they cater to sophisticated investors. In the U.S., laws require that the majority of investors in the fund be accredited. That is, they must earn a minimum amount of money annually and have a net worth of over \$1 million (this criteria can vary), along with a significant amount of investment knowledge. Hedge funds are sometimes referred to as mutual funds for the super-rich. They are similar to mutual funds in that investments are pooled and professionally managed, but differ in that the fund has far more flexibility in its investment strategies.

It is important to note that the practice of hedging is actually an attempt to reduce risk, but the goal of most hedge funds is to maximize return on investment. The name is mostly historical, as the first hedge funds tried to hedge against the downside risk of a bear market with their ability to short the market (mutual funds generally can't enter into short positions as one of their primary goals). Today, hedge funds use dozens of different strategies, so it isn't accurate to say that hedge funds just "hedge risk". In fact, because hedge fund managers can make highly speculative investments, these funds can carry more risk than the overall market.

According to Hedge Fund Research, at the end of 2006 there were approximately 9,500 hedge funds worldwide with about \$1.4 trillion in assets under management. This contrasts to the just over 500 hedge funds managing less than \$40 billion in assets in 1990.

Two and Twenty

"Two and Twenty" is a type of compensation structure that hedge fund managers, and venture capital groups, typically employ. More specifically, this phrase refers to how hedge fund managers charge a flat 2% of total asset value as a management fee and an additional 20% of any profits earned. Fees can vary by hedge fund.

Hedge Funds and Shareholder Activism

Hedge Fund activists tend to act swiftly, initially by growing their positions and making certain demands of the company's management. Ethos Fund, for example, acquired a stake in Nestlé and then pressed for separation of the CEO and Chairman roles. Other hedge funds make far more intrusive demands, including the removal of board directors.

Most observers believe hedge fund activism is on the rise. In an April 18th, 2007 Wall Street Journal article, former SEC Chairman Richard Breeden, now a hedge fund manager himself, wrote that while activists account only for around 5% of all hedge fund money in the market today, this figure could rise to 20% over time.

Even though hedge fund activists pride themselves on secrecy, one of the best avenues for identifying them is also the most public – the 13D SEC filings. Just go to www.sec.gov. and locate EDGAR and search for the name of the company. Then enter the “Form Type” – 13D. If a hedge fund has filed a 13D, it might have activist aspirations.

Some examples of Hedge Funds and their actions:

Hedge Fund	Target	Request	Result
Icahn Partners	Blockbuster and Hollywood	Merger with Hollywood	Failed
Pirate Capital	Intrawest	Acquisition/privatization at higher share price	Successful
JANA Partners, Atticus Capital	Deutsche Borse	Abandon bid for London Stock Exchange, return cash to shareholders and oust CEO	Successful
Loeb Partners	MOSAID Technologies	Company be sold	Failed

Source: Thomson Financial

Empty Voting

The term empty voting occurs when hedge funds either borrow shares or buy equity swaps to gain voting interest in a company without having the equivalent economic interest. This is another trend magnifying the clout of activist hedge funds.

For example, in 2004 when Perry Capital, a large shareholder in King Pharmaceuticals, wanted to ensure Mylan Laboratories proposed acquisition of King went through, Perry bought and shorted almost 10% of Mylan’s share through an off-market derivative transaction negotiated directly through a broker. This gave Perry the right to vote nearly 10% of Mylan’s shares without having any real economic interest in the company.

For investor relations professionals, empty voting is troubling as it is difficult to detect. You should continue to monitor who your shareholders are (with Bloomberg and/or Thomson) and if some of the following names show up then Hedge Funds are involved ...

Prentice Capital Management	New York NY
JANA Partners	San Francisco, CA
Angelo, Gordon & Co.	New York

Citadel Investment Group	Chicago, IL
Brencourt Advisors	New York
Caxton Assoc	New York

What Hedge Fund Activists are looking for from your Company:

- Cheap relative valuation, a lagging stock price and underperformance compared to peers
- Competitive pressures from an underperforming business
- Strong cash generation capabilities, cash on hand, recurring revenue or underutilized, hidden or easy-to-liquidate assets
- Perception that the company that has “missed opportunities” or “undifferentiated” message
- Corporate governance weakness

Hedge funds have been active players in financings for early stage tech and biotech companies. They often buy during financings which offer a unit, one common share and one half to a whole common share purchase warrant, which might be priced at a 25% premium to the common share and have a 3 to 5 year exercise period. They may be covering short positions that they took when they noticed a company’s share price was sliding and the balance sheet indicated that they would need to do a financing. The hedge funds may also just sell their shares into the market, even at a small loss if necessary, hold the warrants as the potential upside, and move their cash on to another investment opportunity.

2 securities lingo brain teaser

What is empty voting?

Answer is in this bulletin.

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