Regaining Lost Ground

The State of the U.S. Financial Industry

Boston College Financial—a magazine written and managed by our graduate students—seeks to bridge the gap between financial research and practice, provide a platform for students to publish their work, and connect with the industry. Following last year’s issue on the Great Recession, we’re pleased to present the sixth issue of the magazine, focusing on the recovery of the U.S. financial industry. Despite lingering challenges, the industry has shown remarkable resilience and improvement over the last 12 months. The aim of this issue is to provide readers with a broad “pulse” on the U.S. financial industry after its near collapse experience two years ago. Our writers have analyzed major market segments, explored tangential markets and drivers, and interviewed industry professionals to help shed light on the opportunities that lie ahead for investors and industry professionals alike. Beyond inspiring and informing the larger graduate school population, this issue will benefit a broad range of finance professionals by helping them understand and then react with insightful strategies to deal with challenges in the ever-changing environment in asset management, private equity, investment banking, venture capital, alternative investments, equity and fixed income markets, and government regulations, among others. Similar to previous issues of Boston College Financial, this edition demonstrates a spirit of passion for finance that we hope will inspire its readers. This magazine not only has an important impact on our students’ careers, but also enhances the reputation of the Carroll School’s graduate programs and allows students to display their academic development to the Boston College community.
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AN EXAMINATION OF
THE CURRENT STATE
OF FINANCIAL REFORM

By Matt Horne and Evan Petrowski

In the wake of the recession, spurred by the collapse of Bear Stearns, poorly rated and collateralized mortgage-backed securities, and the bailout of major financial institutions, came the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. This protracted 2,000-plus-page regulatory bill seeks to, among other things, eliminate the risk of banks becoming “too big to fail” and “clearly states tax payers will not be on the hook to save a failing financial company or to cover the cost of its liquidation.” This article focuses on the current states of systemic risk, leverage ratios, and the Volcker Rule with regard to compliance and the challenges ahead.

SIZE MATTERS—WHY TOO BIG TO FAIL IS JUST THAT

As of March 2011, 329 banks have failed in the United States since the beginning of 2008. Emerging from this crisis is a trend to consolidate, as relatively healthy banks have assumed the deposits of failing institutions. More concerning is the size, measured by customer deposits, of the major national banks and their growth dating back to before the recession (see Exhibit 1).

Prior to the recession, Bank of America was lobbying Congress to bypass a law that required no bank to hold more than 10 percent of U.S. deposits. “It didn’t get very far with lawmakers. But what lobbying failed to accomplish was soon made possible by crisis. As the financial collapse unfolded, regulators made the astonishing decision that the way to deal with failing mega-banks was not to distribute their assets among smaller institutions, but to merge them with one another. Bank of America absorbed Countrywide and Merrill Lynch, and swelled to 12 percent of U.S. deposits. Wells Fargo crossed the 10 percent line when it took over Wachovia in 2008. JPMorgan Chase, fattened on Washington Mutual and Bear Stearns, emerged from the crisis holding 9 percent of our deposit,” wrote Stacy Mitchell, author of The Big-Box Swindle and a senior researcher at The New Rules Project.
THE LEVERAGE RATIO—A COMMON SENSE SOLUTION?

Over the past decade, major banks worldwide have taken on increasing levels of financial leverage (see Exhibit 2), widely viewed as one of the drivers of the severity of the financial crisis. John Cassidy, writer for the New Yorker and author of How Markets Fail: The Logic of Economic Calamities, points out that “[a]lthough short-term gains can be attractive, the costs of crisis mean such a statement lacks credibility. Knowing this, the rational response by market participants is to double their bets. This adds to the cost of future crises. And the larger these costs, the lower the credibility of ‘never again’ announcements. This is a doom loop.”

During the Great Depression, what ultimately helped stabilize the banking system was the Federal Deposit Insurance Corporation (FDIC) insurance placed on deposit accounts. Even if a bank was fated to fail, customers did not panic and cause a run because they knew their money was safe. The dynamics of the banking system have changed since then, particularly after the repeal of the Glass-Steagall Act in 1999, which kept commercial and investment banks separated, notes Ezra Klein of the Washington Post: “Sharply regulating leverage would do something similar. It wouldn’t mean that investments stop going bust and banks stop making bad decisions, but it would mean it mattered less when they did. When Lehman went bust, they were leveraged at 44:1. That meant their investments were 44,000 percent more important to the economy than they’d have been in the absence of any leverage at all, and all of that money was coming from elsewhere, which meant Lehman could make other firms go bust, too. But since no one knew which other firms would go bust, professional investors began taking their money out of the system as a whole. What you want to do is interrupt that dynamic. That could mean insuring the loans that professional investors make to other investors, as Gary Gorton has suggested. It could mean putting such sharp limits on leverage that the failure of one bank doesn’t have the potential to take out five others.”

The Current State of Regulation Implementation

The Dodd-Frank Act does address the two aforementioned concerns. The Federal Reserve, under the guidelines of a two-thirds majority vote and the vote of the chairman, can require large and/or complex financial institutions to sell off holdings if it feels the company poses a “grave threat” to the financial stability of the United States. The Fed also stipulates a floor for capital that “cannot be any lower than the current state” and requires a 15:1 leverage ratio. Both of these regulations would assuage the concern of systemic risk to the financial system and curb excess risk taking by larger financial institutions that implicitly realize they will be bailed out in the event of a market crash.

In his testimony to the Banking, Housing, and Urban Affairs Commit-
Republicans taking control of the House next month have promised to reduce funding through spending cuts and more aggressive oversight of regulators, making the short-term measure potentially problematic for the two agencies.

tee on February 17, 2011, Federal Reserve Chair Ben Bernanke stated that "we have made considerable progress in carrying out our assigned responsibilities. We have been providing significant support to the Financial Stability Oversight Council, of which the Federal Reserve is a member. We are assisting the council in designing its systemic risk-monitoring and evaluation process and in developing its analytical framework and procedures for identifying systemically important non-bank firms and financial market utilities. We also are helping the new Office of Financial Research at the Treasury Department develop potential data-reporting standards to support the council's systemic risk-monitoring and evaluation duties." Clearly, the Federal Reserve has the plans and metrics ready to implement for future oversight whether or not Congress has the political will to continue to fund and support the initiatives set forth by Chairman Bernanke.

Members of Congress, more specifically Republican lawmakers, are hoping to delay and defund the implementation of Dodd-Frank. According to Joshua Gallu and Phil Mattingly of Bloomberg News, "Government funding for the fiscal year ending September 30 has been caught up in partisan battles over taxes, spending, and the meaning of Republican gains in the November elections. Republicans taking control of the House next month have promised to reduce funding through spending cuts and more aggressive oversight of regulators, making the short-term measure potentially problematic for the two agencies. Without that funding, new initiatives will be postponed or scrapped, regulators have said."

Democratic senators have tried to introduce measures to boost funding to the Securities and Exchange Commission (SEC), which oversees the implementation of the Dodd-Frank Act. Republican senators, however, have opposed any measures to boost funding, citing their desire to cut federal spending early in 2011.

**THE VOLCKER RULE**

The Volcker Rule is contained in section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was signed into law on July 21, 2010, by President Barack Obama. Paul Volcker, former chairman of the Federal Reserve, championed the rule, which aims to minimize speculative investing activities by banking entities. The interpretation of the rule and the manner in which it will be enforced could impact the business practices that financial institutions have relied upon to generate earnings going forward.

The Volcker Rule adds a new section 13 to the Bank Holding Company Act of 1956, generally prohibiting banking entities from engaging in proprietary trading or from investing in, sponsoring, or having certain relationships with a hedge fund or a private equity fund. The term "banking entities" refers to any company that is an FDIC-insured depository, controls an FDIC-insured depository, or is treated as a bank holding company. The rule aims to address three fundamental issues. First, banking entities essentially receive a subsidy by nature of their deposit-taking authority and their role as stabilizers of the financial markets; they should not use this subsidy to undertake proprietary business that is deemed inherently risky. Second, if a banking entity is undertaking self-interested proprietary activities while simultaneously advising clients, a

**EXHIBIT 3**

**RECOMMENDED ACTIONS TO EFFECTIVELY IMPLEMENT THE VOLCKER RULE**

Source: Study of Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds, FSOC (Jan. 18, 2011)

The Council strongly supports the robust implementation of the Volcker Rule and recommends that Agencies consider taking the following actions:

1. Require banking entities to sell or wind down all impermissible proprietary trading desks.
2. Require banking entities to implement a robust compliance regime, including public attestation by the CEO of the regime’s effectiveness.
3. Require banking entities to perform quantitative analysis to detect potentially impermissible proprietary trading without provisions for safe harbors.
4. Perform supervisory review of trading activity to distinguish permitted activities from impermissible proprietary trading.
5. Require banking entities to implement a mechanism that identifies to Agencies which trades are customer-initiated.
6. Require divestiture of impermissible proprietary trading positions and impose penalties when warranted.
7. Prohibit banking entities from investing in or sponsoring any hedge fund or private equity fund, except to bona fide trade, fiduciary or investment advisory customers.
8. Prohibit banking entities from engaging in transactions that would allow them to "bail out" a hedge fund or private equity fund.
9. Identify "similar funds" that should be brought within the scope of the Volcker Rule prohibitions in order to prevent evasion of the intent of the rule.
10. Require banking entities to publicly and private equity funds.
The FSOC issued its recommendations on January 18, 2011, and outlined a list of actions that federal regulators should take in order to facilitate compliance (see Exhibit 3).

On February 9, 2011, the Federal Reserve Board finalized the rules for the conformance timelines and extension periods under the Volcker Rule. These were effective April 1, 2011. Although certain aspects of the Volcker Rule are still under review, the law must be effective two years after the enactment of the Dodd-Frank Act (July 21, 2012) or nine months following the joint agency rule making, whichever occurs earlier.

**BARRIERS TO IMPLEMENTATION**

Although the overall goal of the Volcker Rule is clearly stated in the law, the manner in which this end is achieved presents a major issue. Subject to some restrictions, the rule will still allow banking entities to undertake proprietary trading activity and interact with hedge funds and private equity funds. However, these activities may only occur in specific cases, including, but not limited to, acting on behalf of a client, conducting hedging activities, and trading in specific types of securities.

A major challenge of regulators will be the manner in which they characterize trading activity by a banking entity. Banks will still be allowed to act as market makers for their clients under the new regulation as well as purchase securities in “anticipation” of client demand. This invites the banks to continue their lucrative proprietary trading activity but disguise it as “market making” or “client-based.”

A quick glance at the income statements of some of the major investment banks reveals that trading and principal investments make up a significant proportion of revenues (see Exhibit 4). For example, in FY2006, trading and principal investments at Goldman Sachs, JP Morgan, and Morgan Stanley made up 63 percent, 17 percent, and 45 percent of revenues (net of income expense), respectively. In FY2009, these percentages were 64 percent, 10 percent, and 27 percent, respectively. Although the exact amount of the contribution is unknown, proprietary trading contributes to a significant component of earnings for bank entities. The FSOC’s current proposed solution to the anonymity of trades is to develop a metric system to collect trade data. That will ultimately categorize trades as permitted (i.e., hedging, market making, underwriting) or as proprietary by looking at various risk metrics, length of time held, and revenue metrics.

As many panels of experts weigh in on what the finalized Volcker Rule should look like, banking entities have been ensuring their input is heard. According to the Center for Responsive Politics in Washington, D.C., securities and investment industry spent nearly $103 million on lobbying efforts in 2010, of which Goldman Sachs contributed $4.6 million (see Exhibit 5). It is apparent that as the Volcker Rule begins to take final form, banking entities will continue to spend to ensure their interests are maintained. This sphere of influence may impact the manner in which regulators proceed, possibly weakening the goal of the reform.

Another issue threatening the effectiveness of the rule is lack of federal funding for the organizations in charge of implementing the reform. Agencies such as the Securities and Exchange Commission and the Commodity Futures Trading Commission will need increased budgets in order to ensure proper compliance by the entities they oversee. Additionally, these agencies will need to collaborate going forward and delegate responsibilities to ensure appropriate enforcement of the rules.

As the financial crisis fades into the past with the goals of the Volcker Rule unrealized, behavior by banks has not fundamentally changed. That is evidenced most recently by Goldman Sachs’s private investment in Facebook, which some contend goes against the spirit of the Dodd-Frank Act. The merits of the Dodd-Frank Act and the Volcker Rule, although rooted in good intentions, are difficult to enforce and have a long time horizon for compliance. The longer the rules are debated by agencies and lobbyists, the less potential there is for their impact to be felt.

**EXHIBIT 4**

**TRADING AND PRINCIPAL INVESTMENTS**

*Source: FY2007 & FY2009 Form 10-K for Goldman Sachs, JP Morgan, and Morgan Stanley*

**EXHIBIT 5**

**ANNUAL LOBBYING**

*Source: Center for Responsive Politics*
FLUSH WITH CASH

By Mike Leitzel and John Pascucci

In a rush to safety following the largest economic downturn since the Great Depression, Corporate America has amassed the largest build-up of cash and cash-equivalents (CCE) seen in half a century. Cash equivalents are a class of low-risk, low-return securities that include U.S. Treasury bills, bank certificates of deposit, corporate commercial paper, and other money market instruments. By the end of 2010, CCE comprised 7.4 percent of total U.S. company assets, levels not seen since 1959. Companies are sitting on roughly $2.41 trillion of cash ($1.93 trillion of which is controlled by nonfinancial companies), and for the most part, they are not using those funds to boost employee head count, invest in growth opportunities, or pay out dividends.  

Analysts predict that this trend will reverse in 2011 as managers grow more confident that a double-dip recession will not materialize and the global economic outlook brightens. However, looser spending standards likely will not result in a significant jobs boost, as companies that have trimmed their employee count since Lehman crashed realize they can operate leaner than ever before. In fact, the unemployment rate has risen from 9 percent in mid-2009 to roughly 9.8 percent at the end of January 2011. Analysts believe that managers will begin to seek new growth opportunities through increased merger and acquisition (M&A) activity as some companies see acquisitions as the only growth option. After a virtual freeze in deal making, the latter half of 2010 saw a thaw with M&A activity rising 14.2 percent. Moreover, suitors are willing to pay extremely high premiums. In 2010, offers for financial firms received average premiums of an astounding 55 percent.

A key challenge for the Obama administration will be to convince companies that they should use their cash reserves to mitigate the unemployment problem. Although the administration has instituted incentive programs such as cash bonuses and tax breaks for companies that hire those who have been unemployed for a prolonged period, managers are still reluctant to hire unless necessary. Additionally, managers cite pending tax legislation and regulatory uncertainty as the major policy-related impediments to hiring, while ongoing economic risks and the credit crunch continue to be the largest barriers to a jobs recovery.

An important point that often gets overlooked is that the amount of cash on U.S. companies’ balance sheets may not be marked for domestic use. U.S. companies often choose not to repatriate cash generated overseas to avoid paying the relatively steep U.S. corporate tax. Analysts estimate that there are over $1 trillion of foreign earnings not repatriated for tax reasons. According to MIT economist Michelle Hanlon, many companies choose to invest in lower-return foreign assets rather than repatriate cash, and some companies borrow money in the United States rather than use cash generated overseas.

However, there are signs that companies are beginning to spend cash. During the fourth quarter of 2010, cash and short-term investments among S&P 500 companies fell by $50 billion and capital spending increased $22.3 billion. Cisco Systems, Inc., General Electric Co., and the Coca-Cola Co. have recently announced plans to open up their coffers for new capital investments. In addition, the administration has been working closely with executives to build confidence in economic growth through initiatives such as a late 2010 tax break extension and a new measure to accelerate tax deductions on depreciation. Still, Daniel DiMicco, CEO of Nucor Corp., states that companies won’t invest “unless they have the opportunity to be more profitable by doing that as opposed to investing the money someplace else or holding onto it” (emphasis added).

EMPLOYMENT UPDATE

THE STATE OF EMPLOYMENT IN THE UNITED STATES AND IN THE FINANCIAL SERVICES INDUSTRY

By Jacqueline H. Carey

The last several years have been incredibly difficult for the job market in the United States. Though the United States continues to suffer through a historically high unemployment rate, the tide is beginning to change on the job horizon. As of February 2011, the U.S. unemployment rate had fallen to 8.9 percent, down from its October 2009 peak of 10.10 percent. While far from ideal, that is clearly a positive step in the U.S. economic recovery from the highs of 2008 and 2009. So what does this mean for those seeking employment?
in the United States, specifically in the financial services industry? There are several trends to consider, including the continued relevance of the financial services industry, growth areas within it, and competitive advantage for those seeking employment, but most of the signs lead to an increasingly positive outcome for job seekers.

The financial services industry has become an instrumental sector in the United States, contributing about 6 percent to the 2009 U.S. GDP and non-farm employment rolls ($828 billion and 6 million employees, respectively). “The financial services industry provides the fuel that promotes job creation and sustains economic growth and innovation,” according to the Securities Industry and Financial Markets Association. The financial services industry plays an equally important role in the GDP of state and local economies. In New York and Massachusetts, for example, the financial services industry contributed 16.4 percent and 9.7 percent, respectively, to 2009 state GDP, as shown in Chart 1. The financial services sector provides more than just an outlet for individuals to invest their funds; it provides businesses with new ways to lower the cost of capital, stimulates global investment and trade, helps to facilitate and finance the export of manufactured goods, and encourages enhanced price discovery and dissemination of information. Further, as the U.S. government continues to scale back its support of private enterprises, U.S. companies will increasingly turn to the financial services industry to raise funds. For all these reasons, the financial services industry will continue to be vital and critical in the United States and will generate significant employment opportunities.

In light of these facts, it is important to take a closer look at the industry as a whole to see where growth and employment opportunities exist, both currently and in the future. According to the U.S. Bureau of Labor Statistics, employment in securities, commodities, and overall financial services is expected to grow 9 percent by 2018. Specifically, employment as financial analysts, defined as buy- and sell-side analysts for mutual funds, hedge funds, insurance companies, independent money managers, and nonprofit organizations with large endowments, is expected to increase 20 percent by 2018. Market conditions, consolidation, and increased regulation within the industry will continue to be the largest inhibitor of employment growth in the short term. Areas that have experienced the most growth in the past three years include credit, corporate risk, and compliance, according to Sue Sattler, president of the recruitment company Talent Network Group. The year 2010 saw an increase in mergers and acquisitions and an improvement in the mortgage securities area.

As for job prospects for those currently seeking employment in financial services, the most fundamental and useful experience needed to obtain a desirable position within the industry generally includes education, a diverse skill set, and advanced certification. That continues to be broadly true across all industries in the United States, as displayed in Chart 2. Locally, Boston has seen an above-average growth rate in overall employment over the past year, higher than any other U.S. city besides Washington, D.C., as shown in Chart 3. Specifically, the U.S. Bureau of Labor Statistics states that, for the financial services industry, an understanding of statistics, economics, accounting policies, corporate budgeting, and financial analysis methods are recommended. Certifications and graduate degrees, such as a CFA certification or a master’s degree in business or finance, significantly improve an applicant’s prospects as well.

According to Bloomberg Businessweek, 34 percent of business schools’
career services report an increase in internship and full-time opportunities at both the undergraduate and MBA levels. Lou Gaglini, associate director of employer relations at the Boston College Career Center for undergraduates, states that he has seen roughly a 20 percent increase in internship and full-time opportunities overall from last year. Within financial services, he has seen an increasing trend across all subsectors, including asset management, hedge funds, investment banking, and private equity. Marilyn Eckelman, director of career strategies at the Carroll Graduate School of Management, also has seen an improvement in opportunities across all industries. As placement rates for MBA students have increased over the past several years, she believes that the trend will continue for the class of 2011. Though she admits that there has been an improvement in the number of opportunities overall, she states that the environment remains fiercely competitive. “[Financial services] corporations are looking for established profiles and candidates who are highly analytical, technical, and with more sophisticated backgrounds—for example, with quantitative skills or financial engineering backgrounds,” she says. She recommends that students develop a multi-stepped strategy when embarking on their job search. That strategy should include an internship both during the summer after the first year and during a student’s second academic year (for full-time students); developing programming skills, including VBA and Matlab; pursuing the CFA; being a student of the financial markets and the economy; and consistently networking.

Another positive sign for current employment opportunities is that MBAs are receiving higher salaries and bonuses than last year, according to the Graduate Management Admission Council (GMAC). GMAC states that the median salary for new MBAs in 2010 was $78,820, as opposed to $66,694 in 2009, and median bonuses in 2010 were $13,318, almost double the figure for 2009, as shown in Chart 4.4

Here is The City News, a financial services industry website for up-to-the-moment industry and employment information globally, also reported on February 15 that several major investment and brokerage houses were actively hiring, including Bank of America, Merrill Lynch, Barclays, Citi, Credit Suisse, Jeffries & Co, MFS, Nomura, Renaissance Capital, and RBS. These firms have been actively recruiting for positions in investment banking, equity capital markets, research, sales and trading, structured products, multi-asset solutions, and wealth management.

Despite major setbacks over the past several years, the U.S. economy and the financial services industry are recovering. Current and future employment trends are positive and accelerating due to the global economic recovery and the important role financial services plays within it. For those looking to find positions in finance, education and a diverse skill set remain vitally important. Despite the challenges that are still ahead, the financial services industry remains a strong and critical contributor to both the U.S. and global economies. Employment opportunities continue to rise for those who are capable, persistent, and willing to explore the vast options within the industry as a whole.  

**CHART 4**

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<th>OUTGOING INCOME</th>
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<td>The salary picture for business school graduates</td>
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Graduated in: 2008 2009 2010

- Median salary at schools
- Median salary at Harvard
- Median salary at M.I.T.
- Median salary at NYU
- Median salary at University of Chicago

*NYU salaries are average.

Source: GMAC survey of 5,350 business school graduates and their schools

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**WALKING ON BROKEN GLASS-STEAGALL**

**THE EVOLUTION OF BANKING THROUGH REGULATORY REFORM**

By Paul Leblanc

For the past few years, many people have proclaimed their theories behind the cause of the world’s financial crisis. Was it the fault of the homeowners who took mortgages that they should have known they couldn’t afford? Was it the fault of the banks that levered their books to the gills with mortgage-backed securities? What about the regulators or the rating agencies that were supposed to keep the public in line and well informed? The main cause of the financial crisis may still be up for debate, but there is one thing that everyone can agree on: These are scary times for our country. A common way for many to emphasize the severity of our current situation is to draw comparisons to the Great Depression. Images of the Joad family in the *Grapes of Wrath* come to mind. How close are we to loading up the Hudson truck with our family and possessions to embark on a nearly hopeless trip into an abyss of uncertainty?

Few would argue with the notion that sweeping regulatory reform played a critical role in pulling America out of the Great Depression. In an effort to reduce conflicts of interest facing the banking industry, the Glass-Steagall Act was passed in 1933, which formally prohibited commercial banks from taking part in the investment banking and insurance businesses. Along with the banking distinction, the bill also established the Federal Deposit Insurance Corporation (FDIC). The logic behind this law was that in order to restore confidence in the lender/borrower relationship, people needed to have confidence that their money was safe in the hands of their commercial bank, rather
into law on July 21, 2010, which President Barack Obama signed. The Dodd-Frank Wall Street Reform and Consumer Protection Act, passed the Dodd-Frank Wall Street Relief Program (TARP). The Gramm-Leach-Bliley Act allowed commercial banks once again to engage in the investment banking and insurance business. The main argument behind the new law was that commercial banks could not compete with unregulated financial institutions, both foreign and domestic, and that the conflicts of interest, inherent to the combination of banking types, could be mitigated by other forms of less restrictive regulatory oversight. Unfortunately, the commercial banks—like the investment banks—also used enormous amounts of financial leverage in order to take advantage of the seemingly unstoppable bull markets, particularly within the mortgage space. Just 10 years after the Gramm-Leach-Bliley Act, many institutions with long traditions of commercial banking prowess, such as Citigroup and Bank of America, were among the many firms fighting to survive after being forced to write down billions of dollars worth of securities on their books. Due to the scope of the instability among financial institutions, the government was forced to step in to restore confidence in the financial system, with the most significant action being the Troubled Asset Relief Program (TARP).

In late 2009, some politicians, including Senator John McCain (R-Ariz.) and Maria Cantwell (D-Wash.), argued that the Glass-Steagall Act should be reinstated as part of the effort to restore financial stability. Rather than restore the Glass-Steagall Act, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, which President Barack Obama signed into law on July 21, 2010. This act includes the Volcker Rule, which prohibits proprietary trading for banks and restricts proprietary trading for non-bank financial institutions. Has Glass-Steagall been resurrected through the Dodd-Frank Act? The answer is yes and no. Paul Volcker, economist and former chairman of the Federal Reserve, stated that some of the new guidelines set forth in Dodd-Frank are “in the spirit” of the Glass-Steagall Act, in that some of the principles aim to accomplish the same goal of preventing large institutions from taking on high levels of risk that may threaten the overall financial system. Some banks have already taken steps toward restructuring their business model to adapt to these new banking standards. For example, Goldman Sachs has shut down its proprietary trading desk in order to comply with the Dodd-Frank Act’s Volcker Rule. However, it is important to note that limitations imposed by the Glass-Steagall Act might have caused more harm than good if they had been in place over the past few years. Had Glass-Steagall been in effect, many crucial, stabilizing acquisitions would not have been allowed, such as Bank of America’s acquisition of Merrill Lynch in 2009. In addition, Morgan Stanley and Goldman Sachs were able to achieve stability through their conversion to bank holding status—an act that would have been prevented by Glass-Steagall.

In the midst of the most significant financial reform since the Great Depression, the future of the banking industry remains unclear. The Dodd-Frank Act intends ultimately to protect the consumer and the financial standing of the country by preventing banks and other financial institutions from taking risks that threaten the capital markets and broader economy. In an effort to prevent the problems induced by the complexities of derivatives, institutions will have to be more transparent to investors and regulators through more frequent reporting standards. Dodd-Frank also aims to initiate the trading of these derivatives on a centralized clearinghouse platform, which would lead to more control, less counterparty risk, and additional transparency in the system. The council created by the Dodd-Frank Act also reserves the right to impose a 15:1 leverage requirement on companies that appear to threaten the overall financial system. The Dodd-Frank Act is an extremely complex and lengthy bill, so the full impact of the bill would take pages upon pages to evaluate. However, a critical implication of this bill is that it is highly likely that all banks will have to alter their business strategies to survive. The main goal of the act is to prevent any bank from being a systematic threat to the financial system. This could lead to a less concentrated financial landscape if market share becomes more spread out among many financial institutions.

One of the reasons why Steinbeck wrote The Grapes of Wrath was to highlight those responsible for the economic condition that plagued the country. Steinbeck was motivated to write the novel because, in his words, he “want(ed) to put a tag of shame on the greedy bastards who are responsible for this.” Many modern-day works, such as Andrew Ross Sorkin’s Too Big to Fail, William D. Cohan’s House of Cards: A Tale of Hubris and Wretched Excess on Wall Street, and Michael Lewis’s The Big Short, have showed that greed is the common thread and true root of our country’s current financial condition. Potential homeowners wanted better houses. Bankers wanted bigger bonuses. Bond raters wanted to keep being paid by the banks. While we may never be able to agree on who was most to blame for the financial meltdown, everyone would agree that financial reform made a considerable contribution to pulling America out of the Great Depression. Glass-Steagall’s modification of banking helped restore confidence in the financial markets by preventing banks from getting too greedy with customer dollars, but that act has come and gone. We’ll see if the Dodd-Frank Act has a similar effect.
Innovation in the World of Finance

By Femi Ogunjumo

“I think you could argue that all advantage in business is the result of innovation. It’s the result of having done something new and different...that gives you a leg-up on the competition.”

>> Karl Ulrich, author of Innovation Tournaments: Creating and Selecting Exceptional Opportunities

Over the last 40 years, financial innovation (defined here as new products, ideas, transactional methods, or academic theories that have occurred in the field of finance) has created significant individual wealth and has also revolutionized companies, industries, and economies across the world. As a result of the recent financial crisis of 2008, however, financial innovation has come under close scrutiny as a possible cause of the global financial meltdown. Paul Volcker, chairman of the Federal Reserve from 1979 to 1987 and current chairman of President Obama’s Economic Recovery Advisory Board, is one of many voices that is questioning the economic utility of financial innovation. In December 2009, Mr. Volcker said, “I wish someone would give me one shred of neutral evidence that financial innovation has led to economic growth—one shred of evidence.”

So, if Karl Ulrich is correct—if in-
innovation is the source of value (and therefore profits)—how should financial professionals approach this all-important topic? In hindsight, are there, contrary to Mr. Volcker’s opinion, clear examples of financial innovation that have added significant value to the lives of many? What does the future hold for financial innovation? This article attempts to answer these questions and create a platform for useful dialogue surrounding innovation in the world of finance.

HISTORY
Past Financial Innovations
“When Volcker says he wants to see a shred of evidence regarding the benefits of financial innovation, it really makes me laugh or choke (or something) because there’s tons of evidence that’s emerged since the early 1990s in economics and finance that shows (that) countries that have better developed, more open, more competitive, less restricted financial systems do better over long periods of time.”

 PROFESSOR PHILIP STRAHAN,
John L. Collins Chair in Finance,
Boston College

The financial system that powers the U.S. economy (arguably the most developed, open, and competitive financial market in the world) has been the beneficiary of many noteworthy financial innovations and breakthrough ideas. The long list includes:

Black-Scholes Option Pricing Formula
Risk management is one of the primary functions of the financial system (and of financial services firms), and managing risks successfully begins with measuring them accurately. Prior to the 1970s, nobody had discovered a proven quantitative method to put a price-value on risk.

In 1973, one of the most significant academic breakthroughs in finance occurred when Fischer Black and Myron Scholes discovered the options pricing formula that has since been named after them. Although the formula is based on some assumptions that may not necessarily hold in the real world (such as the assumption that volatility remains constant), it provided a sufficient framework to price options and other derivative instruments in a way that quantified many risks and therefore gave investors the ability to hedge against them effectively.

Incidentally, the Chicago Board Options Exchange (CBOE) was also launched in 1973 and it adopted the Black-Scholes method of pricing options in 1975. By 1984, annual volume of options trading exceeded 100 million contracts. The Black-Scholes option pricing formula had helped accelerate the expansion of a new industry of derivatives and options trading. Robert Merton, then a professor of economics at MIT, later expanded the mathematical understanding of the model, and together with Myron Scholes (Fischer Black had died in 1995) received the 1997 Nobel Prize in Economics for his work.

Swaps
Prior to 1971, many developed countries across the world used the “Bretton Woods” system of monetary management where the exchange rates of all major currencies were pegged to the U.S. dollar and the value of the dollar was pegged to that of gold. At that time, the price of oil was also relatively stable and predictable. When the Bretton Woods system was abolished in favor of “floating” currencies and oil prices spiked in 1973 due to the OPEC embargo on the United States, the risks associated with international trade escalated, as did the market demand for how to manage those risks effectively.

Swaps emerged as an ideal solution. A swap, essentially a derivative security, is a financial contract that enables two parties to exchange certain benefits of underlying financial instruments; for example, currency swaps involve the exchange of principal or interest payments of loans in different currencies. The first swap, a currency transaction involving IBM and the World Bank, was engineered in the early 1980s by David Swenson, a Yale Ph.D. who worked at Salomon Brothers. Many different types of swaps are now traded. Some of these include interest rate, currency, commodity, equity, and credit default swaps. The total volume of swaps traded in 2009—according to the International Swaps and Derivatives Association (ISDA)—exceeded $426 trillion!

Securitization
Securitization is the pooling of illiquid assets (such as mortgages and automobile loans) as collateral for newly issued securities. This practice was first implemented by the Government National Mortgage Association (Ginnie Mae) in 1970 when it issued the first “mortgage-backed security.” The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), mandated by the federal government to increase home ownership by expanding the secondary mortgage market, soon followed suit. The simple logic was that if banks were able to sell pools of mortgages off of their balance sheets for a profit, they would have the incentive and the ability to offer credit (mortgages) to many more consumers.

The benefits realized from the securitization of mortgages, such as diversification of risks, more widely available and less expensive credit, and the creation of more investment options, led to the pooling of additional types of loans by the private sector. The first securitization of auto loans occurred in 1985; in 1986, credit card loans were securitized for the first time; and in 1987, the first collateralized debt obligation (CDO), which pooled a variety of debt instruments, was issued by investment bank Drexel Burnham Lambert. The securitization market has experienced tremendous growth since very humble beginnings in 1970—the total outstanding securitized debt in the United States at the end of 2009 was approximately $8.7 trillion.”
Junk Bonds

Junk bonds are firm-issued debt securities that carry a below-investment-grade rating (below BBB for bonds rated by S&P and below Baa for bonds rated by Moody’s). Although the junk bond market existed prior to the 1980s, it consisted mostly of bonds that were originally investment-grade issues that were later downgraded (fallen angels).

The markets staggered into the 1980s after a decadelong bear market and an economic environment with inflation rates above 10 percent. In an attempt to curb rising inflation, the Federal Reserve had aggressively raised interest rates (hitting a high of 19.10 percent in June 1981), but subsequently began lowering them after it felt that the threat of continued rising inflation had passed. It was in this environment of undervalued stock prices, falling interest rates (and therefore declining bond yields), and limited availability of capital that Michael Milken, then a junk bond trader for Drexel Burnham Lambert, created a market for newly issued junk bonds to satisfy the ravenous appetites of the leveraged buyout (LBO) industry.

Since leverage allows limited equity to multiply its purchasing power by many times, LBO deals flourished and it is estimated that more than 2,000 LBO deals occurred in the 1980s. Some notable LBO deals involving junk bonds include the $650 million construction of MGM Mirage in Las Vegas; the billion-dollar takeovers of conglomerates Beatrice, RJR Nabisco, and Safeway by Kohlberg Kravis Roberts & Co. (KKR); and the takeover of the Revlon Corporation by Ron Perelman.

Indirectly, the junk bond market also had huge implications for corporate governance—the possibility of a hostile takeover put pressure on company management to perform better.

Electronic Payment Systems/ Electronic Trading

Electronic payment systems (credit card payments, electronic and wire transfers) and online banking have made the transfer of money faster and more accurate than ever before. In the process, transaction costs have been drastically reduced. That has expanded the ability of individuals and firms to transact business with counterparties in different parts of the world. Along those same lines, innovations such as online brokerage, online trading, high-speed algorithmic trading, and electronic stock exchanges are changing investor behavior and expectations in ways that were previously unimaginable.

CONCLUSION

Innovation in the Future

“The antagonists conveniently draw a phantom Maginot Line between ‘good’ finance—making loans to businesses and trading in stocks and bonds—and ‘evil’ finance—anything beyond first-order instruments. They blur out the pension funds which could use them (derivatives) to hedge investments for retirees’ futures, developing country governments that need them to shield their foreign exchange earnings from wild swings in commodity prices, and high street banks which use them to defend against sudden changes in interest rates and borrower defaults. They reel out a litany of accidents caused by derivatives: the collapse of Barings, the implosion of Long-Term Capital Management, the rogue trading scandal at Société Générale, etc. What they fail to admit is that it was poor risk management, porous back office operations, leaky models, and perverted incentives that inflicted these losses and not the instruments by themselves. I do not deny that the improper use of financial innovation can have radioactive consequences. But the same applies to flying, yet we do not clamor for the illegalization of planes. The positives of financial innovation far outweigh any losses the system has incurred from it. Stereotyping it as the product of greed and testosterone-fueled egos is a gross mischaracterization.”

Closing Note: I thank Professor Jun Qian, Professor Alan Marcus, Professor Philip Strahan, and Professor Ronnie Sadka for helpful comments and discussions.
THE NEW FACE OF HEDGE FUNDS: HIGH-FREQUENCY TRADING

An Emerging Trend or Signal for More Regulation?

By Ralph Menzione

Over the past few years, algorithmic trading has been an emerging trend within the hedge fund industry and is the current scapegoat for the infamous “Flash Crash” of May 6, 2010. The ability to execute market orders electronically has been available to buy- and sell-side institutions and individual investors for decades; however, as technology has advanced, a new type of trading has begun to change the bid/ask landscape. The most profound change as a result of this technology is how hedge funds, specifically high-frequency trading firms, are exploiting and profiting from nanosecond inefficiencies in the financial markets.

Algorithmic trading is the operation of executing trades through complex computer programs that are developed to identify abnormal market conditions. These programs are developed to sift quickly through millions of bytes of market data and interpret signals to execute trades and generate profits. Effectively, an algorithmic model could identify an advantageous market signal for a manager and instruct the individual to trade or have another model automatically execute an order. Furthermore, these trading strategies may have position-holding periods of seconds, minutes, days, weeks, or months. Therefore, the term algorithmic or “algo” trading is fairly generic. To be clear, high-frequency trading, or HFT, encompasses a series of algorithms that can identify a multitude of market signals and execute trade orders based on highly advanced computer-programmed code. The reason that HFT funds are so effective is due to the microseconds it takes for the algorithm to extrapolate the data, identify the abnormality, and execute an order. Intuitively, an HFT strategy can be considered an algorithmic trading strategy; however, an algo trading strategy is not always an HFT strategy. By design, high-frequency traders will be in and out of a position within a very short period of time, with the power to execute thousands of trades in fractions of a second.
DISTINCT ADVANTAGES

High-frequency traders can generate profits through two mediums. The main function of high-frequency trading strategies is to exploit movements in the markets and recognize arbitrage opportunities. In order to mask their intentions from the market, high-frequency traders will put out tiny, 100- to 500-share orders in an attempt to gauge market sentiment. When the algorithm identifies a pending market order, it will execute a buy order ahead of the investor and sell off the position to the purchaser a fraction of a second later. This strategy can also be executed as a short sell.

Additionally, high-frequency traders will act as “market makers” by utilizing the aforementioned profit tactic. Exchanges are willing to pay rebates to liquidity providers, typically one-quarter of a cent on each part of a round-trip trade. Although that is not an enormous sum of money, high-frequency traders will be executing the 500-lot trades thousands of times within an extremely short time period. The profit from the trade coupled with the rebate from the exchange quickly adds up and translates into significant profits.

Since HFT strategies run almost exclusively off computer code, a secondary market has presented itself for HFT funds. Because these systems are executing transactions in fractions of a second, every millisecond counts. Therefore, physical distance from the software source (the physical computer) to the data provider (the exchange) is critical. Storage rooms in close proximity to the exchanges are demanding premium lease rates. This has become controversial with U.S. HFT funds opening operations overseas but still trading domestically. Regardless of where in the world a machine is placed, the closer it is to the exchange, the faster the data are analyzed. That has become another tension point in the HFT world due to the fact that although everyone can have access to the same hardware (supercomputers), physical location can completely change a strategy and outcome of a trade.

From a macro outlook, high-frequency traders provide a very critical part of the exchange chain. As liquidity providers, they are able to keep spreads tight, which lowers costs for institutional and retail traders. Additionally, HFT funds have become increasingly fundamental to U.S. exchanges, where they are estimated to provide between 50 percent and 70 percent of daily liquidity. Although these strategies have made markets more efficient and liquid, they are also profiting off something more than asymmetric information. This issue does not affect the trader employing a buy-and-hold strategy as much as it does a speculative trader. Further, the issue of stock manipulation becomes an increasing concern as these algorithms become quicker and more advanced. As an algorithm is able to read trends and make markets based on order books, certain stocks can become victims of price manipulation. Spikes in volatility, either from economic events or heavy high-frequency trading, can trigger technical analysts and other market participants to follow the trend, which could result in a major sell-off. On May 6, 2010, an issue similar to that occurred, erasing nearly $1 trillion in market value based on an increase in volatility and HFT funds leaving the market, thus drying up the very liquidity they were supposed to be creating.

RISE ISSUES

Through statistical arbitrage, HFT funds are able to take advantage of traders with less technological capacity. High-frequency traders have the upper hand when it comes to more powerful and modern machines, the ability to program a strategy, and direct access to an exchange’s data feed. As an exaggerated illustration of how HFT funds work, consider two traders following the same stock. One trader can watch the fluctuation in price by having two feeds on his or her computer. In this example, let’s consider the stock price is rising. One feed displays the price through a fiber-optics line while another feed displays the price through a dial-up connection. The trader with the dual feed is able to buy the stock at the feed coming in on the dial-up display or fill the sell order, and then immediately sell the position at the price fed by the fiber-optics line or fill the new buy order. The other traders only have access to the dial-up feed and therefore are moments behind the true price of the stock they are monitoring. Not only has the trader with the dual feed made a profit on the appreciation in price, he or she is also able to earn a rebate, paid out by an exchange, for providing liquidity. Of course, this example could be repeated by shorting a stock with the same principles. The main point is that as this is repeated thousands of times a day, the profits add up dramatically. Based on a high-frequency trader’s ability to profit, there has been growing concern and outcry regarding the ease and potentially unethical exploitations of markets.

As HFT has become more popular, exchanges around the globe are racing to make their marketplace more enticing to HFT funds. For exchanges, the increase in liquidity will attract more traders looking for quicker execution of trades than what is currently available. Therefore, in order to court HFT funds, exchanges are touting the speed at which they can execute trades. Currently, the NASDAQ, which has acquired OMX of Sweden in order to take advantage of its technology and is pursuing another acquisition with the NYSE, has the fastest trade execution time at .17 milliseconds. Singapore is spending...
$250 million to generate the fastest execution time at around 0.9 milliseconds. The race to offer the fastest data feed has presented a moral hazard to these exchanges. While they are making a more efficient market for their traders, the HFT funds are getting an advantage through the ability to exploit price discrepancies. What’s more, once an algorithm is developed, it is relatively simple to adapt to different platforms in different nations.

**POTENTIAL REGULATORY CHANGES**

As HFT becomes more popular and the returns gain more publicity, the push for more regulation will become inevitable. Currently, the SEC is discussing rules that attempt to curb the advantage of HFT funds and potentially limit the risk of another flash crash. One rule up for discussion is the “trade-at” rule.6 This rule states that an incoming order cannot be executed unless it was already publicly displaying the best bid or offer in a particular stock. While this is a start, when a trade is considered public knowledge, a supercomputer primed for these conditions can still execute a trade faster than a human physically trading at a terminal.

Another potential piece of regulation abolishes the halting of trading on a stock and instead enacts the “limit up/limit down” rule.7 Under current trading conditions, if a stock fluctuates more than a certain percentage, typically 20 percent, trading is halted and resumes after a certain period of time. Under the limit up/limit down rule, a stock is able to trade within a range; however, if the price moves toward the boundaries of a certain range, trading is not allowed beyond the specified range and orders are canceled. However, traders are still able to trade within the boundaries of the given range of the price of the stock. This approach will limit errant trades from happening outside a given boundary while still allowing trades within the permitted boundary.

The London Stock Exchange is dealing with HFT strategies by eliminating rebates.8 From a nonregulatory view, institutions are fighting back by creating their own HFT algorithms, which are used to confuse HFT funds following institutional activity. In addition, larger investors are trading through “dark pools,” which do not reveal an order’s size or origin, in order to negate an HFT fund profiting from their trading.

As HFT technology becomes more advanced and profits become more lucrative, the trend toward this investing style will become more popular. As it stands, the regulation specifically tied to HFT strategies is not established and those writing the HFT strategies are able to take advantage of the arbitrage opportunities. Based on the ease that a high-frequency trader is able to turn a profit, you can expect that more regulation will begin to find its way into this arena.

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The Future Landscape for Hedge Funds

By Mike Xanthopoulos

Ever since the well-documented and spectacular failure of Long-Term Capital Management in 1998, many questions have loomed about the stability of hedge funds and the amount of risk these private investment pools pose to the global financial system. Some media pundits point to the 2007 collapse of two Bear Stearns hedge funds invested in subprime mortgage-backed securities as the catalyst event that launched the financial crisis. Others argue that a broken financial system as a whole allowed these two particular funds to balloon and burst. The blame game will be debated for decades to come, but because the effects of the failed hedge funds in the spotlight were suffered by far more average Americans than simply investors in the funds themselves, the government decided to take action and explore options to overhaul financial regulation.

To understand the trajectory of the hedge fund industry, one must examine the trends in regulatory reform and how these decisions have or will affect more recent legislation. The most directed change during and following the collapse of Lehman Brothers and the bailout of AIG was the ban on short sales of 799 financial company stocks.9 The move is considered to mirror a plan by the larger European Commission to monitor the risk of short sellers. A patchwork approach, however, will not accomplish the goals of increased transparency and risk mitigation—the stated goals of the rule-making bodies. As new regulations such as the daily...
registration of short positions only affect investment managers who conduct business within that regulator’s domicile, fund managers will likely avoid operations within those borders.

What Does This Mean for U.S.-based Hedge Funds?

The 2008 financial crisis was a crash course in the effects of globalization on the financial markets. What we should take away from this lesson is the fact that European regulations will ultimately affect U.S. regulations. The fact that France has managed to pass its most recent regulations does not necessarily mean the entire European Union will be as aggressive in its efforts to manage risk, but the sentiment in Washington, D.C., appears to be striving toward the same goals.

In the event that some of the details of the Dodd-Frank Act are worked out to include similar regulations in the United States, fund managers would argue that these sorts of disclosure rules would allow unsophisticated investors to copy the strategies of successful managers, and in the case of short positions, create additional downward pressure on stocks from imitation investors. While this seems like it would benefit hedge funds in terms of realizing increased profits from their own original bets, the increased volatility generated by these price movements increases the difficulty managers have in finding true valuations. Andreas Halvorsen of Viking Global Investors LP noted in his April 13, 2010, letter to investors that:

“The problem of crowding is most acute in our shorts due to the risk of unlimited loss and the potential for cancelled borrow arrangements. Here we do tread carefully. As you are aware, we are guarded in disclosing our shorts to anyone and we do on occasion limit the size of our positions, or eliminate them alto-

gether, when we perceive a position to be tight in the borrow market or crowded by equity long-short investors.”

The Volker Rule is a piece of the Dodd-Frank Act that will affect hedge funds in two ways going forward. The most obvious way is the provision that restricts banks’ stakes in hedge funds. Banks are still permitted to start hedge funds, but after a period of one year, may not have a stake larger than 3 percent. The secondary effect of the rule stems from the elimination of proprietary trading practices at banks. These departments will either be spun off as start-up hedge funds, the employees will leave to join other hedge funds, or the banks will simply put the money that was being managed by the prop desk in the hands of a large hedge fund manager with a high-quality track record. A recent announcement by Goldman Sachs is a perfect example of this outcome. The company will close its Global Macro Proprietary Trading desk to comply with the Volker Rule, and employees in the London office are said to be in talks with London-based Global Macro hedge fund giant Brevan Howard.

Discussions of the unintended consequences of financial regulations have become commonplace among academics and industry experts. The most popular items on the docket include the effects on performance of existing managers and the eventual effects on the investors themselves.

While the passing of the Dodd-Frank Act represented a landmark in overhauling the U.S. financial system, it contains many loosely or entirely undefined points that are still being debated. Hedge fund managers have expressed different views on the effects of regulations, mirroring the uncertainty of the markets. In his letter to investors dated June 11, 2010, Third Point LLC’s Dan Loeb noted:

“While the administration seems perfectly willing to allow this ‘regulatory volatility’ to send markets for a tailspin
every few weeks, it does not seem to understand that the corresponding diminution of confidence by allocators of capital in financial markets runs a high risk of spilling over into the decisions by business people to allocate resources to the ‘real economy.’ ‘Main Street’ is not independent of Wall Street. We are each part of an intricate ecosystem and the failure to lay out clear rules of the road in intellectually honest tones is beginning to show signs of sabotaging the overall recovery.”

Still, there are other managers who believe navigating the regulatory landscape is not necessarily a roadblock, but simply another hurdle to separate high-quality managers from those less suited to manage large portions of the fortunes of the world’s largest institutions. Viking’s Mr. Halvorsen told his fund’s investors:

“While we do not believe there is cause for imminent concern, we remain cautious until there is more clarity as to how governments intend to reduce their debt burden and the effects this may have on the global economy and opportunities for corporate revenue growth and margins.”

Investors choose the hedge fund managers to which they allocate capital based on a number of quantitative and qualitative factors, such as performance track record, risk metrics, investment strategy, size of the portfolio, fee structure, and the transparency of the manager. The fee structure of the fund and the transparency of the manager could be affected by regulations limiting management or performance fees charged and requiring daily registration of all portfolio positions. As pointed out by Mr. Halvorsen, crowded trades can cause managers difficulty in sourcing quality investment ideas. That, in turn, could create a drag on performance. Since performance is essentially the product the investor is paying for, increased competition among existing firms would give the investor more choices. However, to stay true to their investment mandates and because it may take longer to find quality investment ideas, managers would insist on longer lock-up periods for their investor’s capital. In return for sacrificing liquidity, investors would then demand higher performance. This cycle could lead to more instances of unethical behavior as managers struggle to keep up with investor demands.

Regulatory Reform: Quality, Not Quantity

One example of an area that would benefit from more targeted and higher-quality regulatory oversight lies in the process by which shareholders in hedge funds are granted liquidity. Generally, there are quarterly, semi-annual, or annual windows during which shareholders may redeem from a fund. However, the shareholder’s money is not returned until 45-60 days later for several reasons, one of which is to avoid negatively impacting the performance and liquidity of remaining investors. While this practice in itself is not screaming for reform, the fact that many hedge fund managers and their employees have a substantial portion of their own wealth invested in their funds has the potential to cause conflicts of interest in terms of the timing of redemptions. Managers and employees possess the inside information as to when flows are coming in and out of the fund. A fund facing a significant number of redemptions during one window could experience excessive downward price pressures as the manager scrambles to sell securities, which in turn would cause the value of his own shares to decrease with everyone else’s. However, because he knows the outflows are coming ahead of time, he could potentially redeem his shares before those of his investors to avoid a loss. In response to investor complaints regarding limits placed on redemptions by one particular hedge fund in 2008, the former SEC commissioner Elisse Walter noted in testimony before the House Financial Services Committee, “Principals, employees, or favored investors of the hedge fund adviser may have received ‘preferential redemptions’ from the fund at issue.” In a recent study on the effects of insider fund flows on fund performance, Gideon Ozik of EDHEC Business School and Ronnie Sadka, professor of finance at Boston College’s Carroll School of Management, suggested a course of action for regulatory reform:

“Similar to the prevention of insider trading in publicly traded corporate securities, fund managers should be required to disclose their intention to subscribe to or redeem shares from the funds they manage to avoid the appearance of front-running their less-flow-informed investors. A potential resolution might involve the imposition of tighter share restrictions on fund managers and insiders in comparison to outside investors.”

Another prime example of an agency problem became evident when Harbinger Capital Partners founder Philip Falcone accepted a personal loan of $113 million from his fund, which was collateralized by his holdings in it. SEC investigators claimed that the fund misled investors by not disclosing the loan in a timely fashion, but Mr. Falcone claims it was made in accordance with the terms of the fund and was disclosed in the firm’s 2009 audited financial statements. He also stated that the loan “was reviewed by our accountants and outside legal counsel.”

In the wake of the financial crisis, many believed that the problems of the global economy arose from a lack of regulation and oversight. Perhaps the issue is not the number of regulations to be levied on the investment industry, and in particular on hedge funds, but the quality and purpose of those regulations. The situation is somewhat analogous to treating the symptoms of an ailment as opposed to finding and treating the root of the problem.
In the wake of one of the deepest economic downturns in U.S. history, middle-market merger and acquisition (M&A) activity has made a noticeable return—a direct result of improving general market conditions and a more favorable deal environment. While transaction volume has remained relatively stable, deal value has improved substantially. Strategic acquirers with deep cash reserves continue to seek synergistic consolidation opportunities, sales and profit growth, and innovative, new products or services that are easier to acquire than to develop organically. Financial buyers with an estimated $490 billion of “dry powder” are seeking platform acquisitions that are scalable and exhibit a clear path to growth, as well as bolt-on opportunities. Additionally, easier access to the credit markets has fueled improvement in middle-market deals—valued at less than $500 million in transaction value. Specifically, debt has become less expensive with tighter credit spreads and terms that are less restrictive for both collateral and covenants, thus increasing leverage in deals and driving up valuation. That is a dramatic turnaround following the stringent correctional mechanisms lenders employed during the credit crisis.

The near-term outlook is bright for middle-market M&A, which is often considered the heart and soul of the broader M&A market. The last few years have been characterized by transactions involving distressed businesses. However, companies that have been able to weather the challenging environment successfully are now well positioned to command a stronger valuation in a marketplace increasingly populated with capable, less-risk-averse buyers. Deal volume and valuation will continue on an upward trajectory in the near future, as pent-up deal supply meets pent-up deal demand in good market conditions. Accordingly, the remainder of 2011 should yield enormous competition, more pristine deals, and high valuations—beginning with larger transactions and ultimately trickling down to the lower middle market.

U.S. middle-market M&A volume suffered greatly during the credit crisis and global recession. In 2007, there
were well over 10,000 deals in this segment; however, the second half of 2008 saw a noticeable decline in volume, with a 17.3 percent drop, year over year (see Exhibit 1). Volume has not yet recovered to historical highs of the past decade, although 2009 and 2010 were indicative of relative stability, with roughly 7,600 deals in each year. While on the surface 2010 volume is not immediately suggestive of improving conditions, only 3 percent of transactions involved a distressed target compared with 7 percent in 2009, when an abundance of companies were forced to sell or attempt to salvage remaining value rather than subject shareholders to further uncertainty and risk. For a short period, there was speculation that 2010 deal volume would receive a boost from sellers planning to take advantage of favorable capital gains taxes before the pending tax cut expiration at the beginning of 2011. However, this trend never materialized and favorable tax rates ultimately continued. Improving company performance should be followed by an upswing in M&A volume over the next several years, as businesses continue to clean up their operating models and balance sheets and establish more marketable positions within the competitive landscape.

The total value of announced U.S. middle-market deals in 2010 was $182.8 billion, up nearly 54 percent from the 2009 aggregate value of $119.1 billion (see Exhibit 1). Indicative of a resurrection of acquisitions involving quality targets, the spike in deal value is an extremely positive sign for future M&A prospects. Additionally, average deal size continues to rise. The year 2010 saw the highest average transaction size in the last 10 years for middle-market M&A with disclosed transaction values. Buyers whose cash reserves grew while sitting on the sidelines during the recession will continue to drive this trend, as they are willing to commit cash to larger deals in an improving environment.

**CONSOLIDATION OPPORTUNITIES DRIVE SECTOR ACTIVITY**

Improved company performance, easier access to the credit markets, and an alignment between deal supply and demand continue to drive deal values upward across nearly all industry sectors in the United States (see Exhibit 2). Over the last few years, the energy and power sector has been the busiest in terms of deal activity in the middle market, and the largest in terms of total deal value with a $31.4 billion total in 2010. Several factors continue to drive value and volume in the energy space, such as the enormous supply of shale gas in the United States and international players’ increasing desire to acquire upstream assets in light of the regulatory uncertainty surrounding deep-water oil exploration in the Gulf of Mexico. U.S. energy companies have also been able to invest wisely and successfully manage their cash flow during challenging economic conditions, enabling them to maintain strong valuations relative to other industries. Additionally, because this sector is largely a commodity business driven by prices, the rising prices of oil and gas have placed upward pressure on valuation. The average North American energy and power transaction in 2010 was valued at 15.1 times earnings before interest, taxes, depreciation, and amortization (EBITDA), up 136 percent from 6.4 times in 2009—the largest year-over-year percentage gainer across all industries.

Both the technology and financial services sectors have seen considerable activity over the last several months. The tech sector has been driven by an appetite for acquiring innovative product developments while financial services is seeing an increase in deal volume and value due to a changing regulatory climate and subsequent divestitures of certain business units.

**FINANCIAL BUYERS AND THE RETURN OF THE LBO**

Financial buyers (private equity groups) played a very important role in strengthening middle-market M&A
in 2010, announcing more than 900 acquisitions of middle-market companies worth approximately $27 billion in total enterprise value, and representing 13 percent of total acquisitions—a 2 percentage point improvement over 2009.7

Recovering economic conditions stimulated activity among financial buyers for several reasons. The economic collapse in late 2008 to early 2009 caused businesses across all industry sectors to suffer greatly. Top-line sales were decimated, and it was too late for companies to implement effective cost-cutting measures in an attempt to salvage profitability. Given the depressed growth and profitability levels of numerous portfolio companies belonging to private equity groups, there was an abrupt shortage in exit opportunities. In addition to a lack of potential acquirers and a weak IPO market, these companies could no longer command a valuation that would yield a satisfactory internal rate of return (IRR) to investors. Without a liquidity event in sight, private investment firms were forced in large part to delay planned exits and extend hold periods to longer lengths. In 2010, businesses began to emerge from the trying recessionary environment—top lines improved with stronger business-to-consumer (B2C) and business-to-business (B2B) spending, and profitability rebounded to favorable historical levels. Given the intrinsic improvement among businesses in 2010, private equity groups were presented with a more marketable position for their holding companies and could subsequently achieve higher valuations through a liquidity event. They are looking to continue selling these portfolio companies in a more active marketplace.

Additionally, the tight credit markets made it extremely difficult for private equity groups to execute their traditional leveraged buyout model. They were forced to contribute unprecedented levels of equity as a percentage of the total deal consideration, squeezing their return profile and increasing their risk. While equity as a portion of total deal consideration is still high compared with historical 10-year lows, 2010 marked the beginning of what appears to be a downward trend in equity contribution and expanding leverage multiples for both senior and subordinated debt. In 2010, leveraged buyouts were funded with approximately 41 percent equity contribution, compared with an astounding 46 percent in 2009.8 Credit markets continue to improve, as lenders provide easier access through more favorable rates and less restrictive covenant and collateral requirements. While equity contribution as a portion of total deal consideration is still well above the near 30 percent lows that occurred from 2005–2007, it will continue to fall as the credit markets heal.

LESS DISTRESS MEANS BETTER VALUATIONS

Above-average financial-performing companies continue to command a premium valuation in today’s market. A surplus of sub-par quality businesses for sale in recent years has dragged down aggregate valuation, as financial and strategic buyers alike have been able to “prey” on distressed businesses to complete acquisitions at bargain prices. Recent quarterly year-over-year valuation multiple comparisons are indicative of a strengthening market. Among financial buyers investing in lower-middle-market companies of less than $250 million in enterprise value in 4Q 2010, the average valuation was 6.1 times EBITDA, compared with 5.4 times EBITDA in 4Q 2009.9 Additionally, above-average financial performers commanded a 12 percent valuation premium relative to underperforming businesses during the same period of review. In addition to quality of financial performance driving higher valuations, size also continues to be a significant influence. In 2010, lower-middle-market companies with greater than $6 million of EBITDA traded at over a 5 percent premium over companies with below the $6 million threshold. Similarly, the same trend occurred in 2009, when companies with more than $6 million in EBITDA commanded nearly a 4 percent premium over smaller businesses.

Often, higher valuation is largely a function of competing bids. Unfortunately, businesses that went to market during the recent turbulent economic conditions were not able to successfully elicit a competitive process due to a shortage of buyers, weak access to the capital markets, and the general weak nature of their financial performance. While most of these sellers remain “for sale,” they are much better aligned in the current improved market conditions to receive multiple bids, establish a competitive process, and ultimately achieve a higher valuation for their businesses.10

BRIGHT PROSPECTS AHEAD

Middle-market M&A in 2011 is off to a tremendous start. All signs point to a prosperous finish to the year, with noticeable improvements in volume, valuation, and deal quality. The underlying theme surrounding a continued resurgence is the surplus of healthy businesses for sale within a favorable deal landscape. Cash-heavy strategic and financial buyers are primed for acquisition while private equity groups are also positioned to realize exits and hope for strong returns on an abundance of well-incubated portfolio holdings. With fears of a double-dip recession dampened and a favorable outlook for key economic indicators, the relaxed credit markets should continue to help fuel M&A activity. The last few years were extremely trying for businesses and consumers alike. However, opportunity has returned with a vengeance on both sides of the transactions, as market forces have convincingly realigned to carry the M&A market forward with considerable momentum through 2011 and beyond.11
The Health of the Mutual Fund Industry

By Tom Gibson

Mutual funds are the first, and in many cases only, option that many investors choose when deciding on their investment strategy. And why not? Generally, the average investor is not market savvy and, even if he or she were, the time required to manage an investment portfolio actively can be significant. Therefore, investors wanting access to professional fund managers and the benefits of diversification have invested their savings in many kinds of mutual funds. Mutual funds, like most investments, were not immune to the financial crisis of 2008; many investors lost faith, and much of their investment, and sought haven in less risky places, be it a bank account or under their mattress.

With the economy seemingly turning itself around, or at the very least the financial markets showing signs of life, how are mutual funds faring? It seems that investors are slowly but steadily entrusting their money to mutual funds, with equity and bond funds seeing the greatest inflows. A look at how fund flows—and as a result, the major money managers—are reacting to the post-collapse environment may shed some light on the future of mutual funds and their role in the world of investing.

Mutual Funds of Yesterday

Mutual funds offer institutional and retail investors alike access to professionally managed investment portfolios that, in exchange for management fees, ostensibly offer a greater return than investors could otherwise earn on their own. Take the Blue Chip Growth Fund of T. Rowe Price (MUTF: TRBCX) as an example. This fund holds stalwart stocks Apple, Amazon, Google, and American Express, among others. It gave investors an average annual return of 10.2 percent from June 2003 to June 2008 with only 0.61 percent of assets invested as the annual management fee. Earning a net 10 percent without needing to manage the investment actively is quite appealing to most investors. Returns like these are the reason that the mutual fund industry flourished, with fund inflows growing a yearly average of 47.8 percent from 2005–2007 and reaching a high of $271 billion in 2007.

The financial crisis that began in 2007 and came to the equity market in full force between September 26 and October 10, 2008, saw the Dow Jones Industrial Average drop 25.79 percent in a two-week span. Investors, fearing dire investment positions, took the natural tactic to halt further investments in mutual funds. While inflows averaged nearly 50 percent the previous two years, 2008 saw only $79 billion in net inflows, a 71 percent decrease from the prior year. In fact, the mutual fund market fared so poorly that the Wall Street Journal reported 97 percent of all U.S. equity-based mutual funds with assets over $100 million (more than 2,300 funds in total) had a negative return between January 2008 and January 2010.

Investor Shift

So, what is the current state of U.S. mutual funds, and where are investors putting their money? Investor confidence in the market has rebounded slightly, with total inflows into U.S. mutual funds up 3.5 percent in October 2010 compared with December 2009. However, the most telling sign of a shift in mutual fund investor behavior is not the net increase in total flows but the change in dollar allocation by fund type. Investors, in the wake of the financial crisis, removed their money from risk-seeking funds; namely, funds heavily invested in the equity markets. Equity funds lost $238 billion in assets in 2008 after experiencing a positive net inflow of $591 billion in 2007. As the equity markets turned northward between December 2009 and November 2010, investors began to move their money back into riskier funds, such as bond and equity funds, and out of liquidity funds (see Figure 1).

Money market funds experienced a 5.6 percent drop in invested dollars while total flows into equity, bond, and hybrid funds increased by an equal 5.6 percent. Kurt Brouwer, founder of the mutual fund consulting firm Brouwer & Janachowski, says that while money market funds are an “important part” of an investment portfolio due to their low-risk investment strategies, there is a real risk that money market funds could “break the buck,” meaning that the net asset value (NAV), or price per share falls below $1. Money market funds attempt to maintain a strategy that never loses money, but if the NAV falls below $1, that means investors are losing money on their supposedly extremely low-risk investment. As investors see others flee from money market funds, Brouwer posits, a cycle of outflows could occur with investors leaving a fund pushing the fund’s value down, inciting more investors to leave. And with money market rates...
being historically low, it is difficult for money managers to attract inflows.

Brouwer’s theory may have some merit, but the most likely cause for the outflows is simply that investors see the bond and equity markets—and their far higher returns—and want to see their money grow. Why would an investor keep his or her money in a fund when you consider the return, net of fees, could be nearly zero? Instead, investors see improvement in the financial markets and are assuming more risk to get far greater returns.

The shift to potentially more risky investments by investors is under way; whether this shift continues remains to be seen. As seen in Figure 1, the total flows into bond funds for the last year increased by 1.3 percent versus a 1.8 percent increase for equity funds. One reason could be that while investors are more willing to take on risk, they are still somewhat fearful of the volatility that can be present in the equity markets. William Ehart, business reporter at the Washington Times and former senior financial reporter at T. Rowe Price, agrees and notes that two bear markets in 10 years have “sapped investor confidence in the fairness of the stock market and its ability to rebound in its usual fashion in the near term” and that is the reason they are pushing more new funds into bonds than equities currently.

Bonds versus Stocks

We can look at the differences between stock and bond investing to make some sense as to why investors have been favoring bond funds over equity funds. First, let’s look at bond fund investing. There are two ways to think about investing in bonds: You can hold a bond to maturity and collect the interest payments or you can think of the bond as a tradable security. The primary risk for an investor who expects to hold the bond to maturity is the ability of the issuer to pay the interest and face value back, which is also known as default risk. However, when an investor purchases a bond and treats it as a tradable security, he or she now faces a risk that the market price of the bond may decrease. These market prices, the value at which a bond can be bought or sold on the secondary fixed-income market, are tied to the bond’s coupon, or interest rate, which is itself tied to the general creditworthiness of the issuer, the length of the issuance, the firm’s financial health, and the required rate of return the market has at the time of pricing.

One way to lessen the risks associated with owning a bond is to buy into a mutual fund. For example, owning a single $1,000 par bond paying a 6 percent coupon with a five-year maturity exposes you not only to the risk of the firm defaulting on the bond, but also to all of the previously mentioned market risk. Alternatively, buying into a mutual fund that holds 20 equivalent bonds for $1,000 reduces the overall default and company-specific risk through diversification. In essence, a company defaulting on a bond or having a disastrous quarter is much less impactful if you own a share of 19 other bonds than if you only hold one bond.

Bond prices recently have experienced less price volatility than stock prices. Figure 2 details the price of the S&P 500 Index (NASDAQ: SPX) versus a simulated price of an aforementioned 6 percent coupon, five-year bond. An investment in the S&P index is more volatile, and recently more profitable, than the bond investment, assuming the same starting investment in both the bond and the index.

The Evolution of Major Investment Management Firms

In the wake of the financial crisis of 2008, the asset management industry took on a different shape. Major consolidations occurred; most notably, BlackRock purchased Barclays Global Investors, the largest global money manager by assets under management in 2005, to become the largest money manager in the world, with assets under management exceeding $2.5 trillion. Large players Fidelity and State Street have seen small asset gains while fellow top 10 competitors by assets under management (AUM) Allianz (PIMCO), BNP Paribas, Deutsche Bank, and Capital Group have seen vast increases in AUM. Figure 3 shows the top 10 asset managers by size in 2009 and their growth from 2005 to 2009.

In terms of the largest firms, there seems to be a trend toward growth in

![Figure 2: The pricing trend of a bond paying a 6 percent coupon at five years’ maturity versus the S&P 500 from 10/2009 to the present.](http://www.towerswatson.com/assets/pdf/2942/)

![Figure 3: Ranking of the top global asset managers as determined by total assets under management.](http://www-towerswatson.com/research/pdf/)


AUM across the board, with two of the largest firms, Fidelity and State Street, seeing moderate growth and firms that were smaller pre-financial crash, like Allianz, BlackRock, BNP Paribas, and BNY Mellon, seeing high levels of growth. The growth is primarily due to these formerly smaller competitors expanding globally, according to a Bloomberg article from 2009. In addition to gaining new international clients, Bank of New York and BlackRock underwent large-scale mergers, with Bank of New York merging with Mellon Bank and BlackRock merging with Barclays Global Investors and Merrill Lynch Asset Management.

Future Outlook

Investors are increasingly leaving the perceived security of fixed income funds in favor of equity funds, presumably due to signs of a strengthening economy and a steady rise in equity indices over the past year. It is not difficult to see why investors are returning to equity funds: The S&P 500 Index is up nearly 23 percent since July 2010. A seemingly rebounding U.S. economy combined with renewed faith in the stock market has investors seeking higher returns, and they are finding them in equity mutual funds. Nick Dedes, a fund analyst for Morningstar, states that the resurgence of equity funds may also have been triggered by more quantitative easing, implying that the federal rates will be kept low and bond prices will remain high, and investors may use the further injections of federal funding as a reason to buy more stocks.

If the stock market continues its rally and the interest rates are held low, it seems that both the bond and equity markets will remain intriguing to investors, while money market funds will remain less appealing due to their lower returns. Conversely, if the markets take another downturn, expect the money market funds, and their lower risk approach, to get more attention.

The Return of Private Equity

By Richard Lemerise

After private equity activity reached a 10-year low in 2009, during the dark days of the economic recession, the industry experienced a modest comeback in 2010, with a doubling of new capital invested and the third best year for exits on record. However, capital invested remained significantly below the boom years of 2006–2007, and the industry continued to struggle to raise new funds. Moving forward, activity in the private equity industry should continue to improve as hot initial public offering (IPO) and mergers and acquisitions (M&A) markets enable exits and deal flow, and an improving economy eases fundraising.

Private Equity Background

A booming private equity industry requires a steady flow of cash through the private equity life cycle (see Figure 1). Private equity groups build investment funds by raising capital from wealthy individuals or institutional investors, who become limited partners in the fund. Capital from the fund is then invested in firms, commonly through a buyout. Acquired firms become part of the fund’s portfolio and are held until their value increases through sales growth or operational improvements. The investments are then exited through an IPO, corporate acquisition, or secondary transaction. The proceeds from investment exits, less typically 20 percent for the private equity group, are distributed back to the limited partners. If market conditions cause cash to stop flowing through any part of the life cycle, then the industry suffers. For example, if investments cannot be exited due to a bad IPO market, then private equity groups cannot make distributions back to limited partners, making them reluctant to invest in new private equity funds. If private equity groups cannot raise funds, then they will not have the capital to make investments, causing the system to break down. To understand the current state of the private equity industry, each part of the cycle must be analyzed.

Fundraising

Fundraising was the only aspect of the private equity life cycle that did not improve in 2010 compared with 2009. The 2010 global fundraising total of $225 billion was the lowest total since 2004, with only 484 funds achieving a close during the year. Funds close when they stop fundraising, preferably having reached the fund’s target size, and begin investing the raised capital. Of 2010’s closed funds, those focused on buyouts accounted for the largest portion, with 88 funds collecting $68.5 billion. These included Blackstone Group’s $13.5 billion Blackstone Capital Partners VI fund, which was more than twice the size of the next largest fund.

That marks a significant change from the record fundraising years of 2006 and 2007 when multiple funds exceeded $10 billion, with some over $20 billion. Although fundraising reached record scale in 2006 and 2007, the time it took to raise these funds was only 11 months. In 2010, the average time to close a fund was more than 20 months, an alarming figure for the 1,600 fund managers on the road globally in early 2011 with the hopes of adding $600 billion to coffers.

There is some hope for those raising funds; 62 percent of investors interviewed by alternative investment research firm Preqin expect to make new fund commitments in 2011. Still, short of a fundraising explosion matching the boom years of 2006 and 2007, a significant number of funds will never
reach their target fundraising level. That creates a competitive fundraising environment that even private equity giants are responding to proactively. KKR, one of the industry’s largest firms, has announced its intention to raise a new North American buyout fund with a minimum rate of return, or hurdle rate, that must be met before the firm can take profits. This hurdle rate feature is a clear effort to attract investors and indicates that private equity groups may be willing to be creative and share some additional risk with limited partners in order to raise new funds.

Dry Powder
Part of the fundraising challenge is the near record amounts of dry powder held by private equity firms. Dry powder refers to the capital committed to a private equity fund that has yet to be invested by the fund. At the end of 2010, U.S. private equity groups held $490 billion in dry powder. With so much idle capital, potential investors see that there is insufficient deal activity in the industry and they are reluctant to make capital commitments. Also, a large portion of the dry powder was raised during the fundraising boom from 2006 to 2008, meaning the funds are approaching investment deadlines. Firms usually have three to six years to call committed capital, unless an extension is requested and granted. That means a significant portion of the current dry powder will either be invested or expire within the next few years, causing a need to raise new funds. That explains why KKR is still planning to fundraise in 2011 even while sitting on almost $5 billion in unused capital commitments.

The Deal Environment
As private equity funds become more desperate to put dry powder to work, they will be increasingly aggressive in bidding for deals. Competition for the best acquisitions will be stiff, as corporations are also set to enter the M&A market with record amounts of cash and an appetite for strategic acquisitions. The potential bidding wars between private equity groups and corporations for the top M&A deals are likely to drive up deal multiples and, thereby, drive down the returns of funds investing at these higher multiples.

Although capital invested by U.S. private equity funds more than doubled 2009 levels, investment has not yet climbed back to even pre-boom levels (see Figure 2). However, of the $132 billion invested in 2010, $50 billion was from deals in the fourth quarter, the highest single-quarter total deal value since the third quarter of 2008. Private equity groups holding billions in dry powder are surely hoping the industry builds on fourth-quarter momentum and provides a 2011 environment that lets them put money to work.

The jump in overall private equity investment was not distributed evenly across all deal sizes. There was a dramatic increase over 2009 in middle-market deals between $500 million and $1 billion (see Figure 3). In 2009, this range accounted for 4 percent of deals, with a total value of $11.5 billion. In 2010, activity at the middle-market level jumped to 12 percent of deals with $40.9 billion in total value. The value of middle-market deals was much larger than any other deal size, with the next closest being deals over $2.5 billion, which totaled approximately $27 billion in deal value. The only year with a higher middle-market deal value was 2007, but there was almost $600 billion in total investments that year. Whether it is because private equity groups are not ready to take on the risk of multibillion-dollar deals or the debt markets are not ready to support the leverage in such deals, 2011 should see a continued focus on the middle market.

Although the typical deal size shifted in 2010, the top two sectors for deal activity remained business products and services and consumer products and services. Figure 4 shows the breakdown of deal activity per sector. The only change from 2009 is that the health care sector jumped over the IT sector to be the third most active sector. Moving into 2011, Hiliter Harris, cofounder of investment bank Harris Williams, expects consumer and retail deals to remain hot and predicts a rise in technology, health care, energy, and financial sector deals.

Exits
Although improved investment activity is a great sign for private equity groups, the invested funds can only generate returns if there is also a market that allows them to exit investments at a high valuation. During the recession in 2008 and 2009, the M&A and IPO markets were nonexistent because corporations were hoarding cash and the depressed securities market limited the profitability of stock offerings. That led to an increase in the me-
dian time private equity groups held portfolio companies, from approximately 3.5 years in 2006 and 2007 to more than five years in 2010. Funds now have the largest portfolio of companies in history. Private equity funds will be increasingly eager to exit investments in the portfolio companies they have held the longest to generate returns and provide distributions to limited partner investors. Additionally, some portfolio companies need to generate funds to pay down debt used in high-level acquisitions during the economic boom when the debt markets were loose.

Fortunately for private equity funds, 2010 was the third best year for exits in history with 480 exits, almost double the number in 2009. Private equity funds exit investments through corporate acquisition, IPOs, and secondary transactions (PE firm to PE firm). In 2010, corporations began spending the cash that was accumulated during the recession, improving stock markets made IPOs possible, and high levels of dry powder drove fund-to-fund acquisitions.

Private equity funds will continue to see strong exit opportunities through 2011. Corporate cash stockpiles and dry powder will continue to drive acquisitions, and the IPO market is showing strength. Through late February, there had already been 11 private equity-backed IPOs raising a total of $10.2 billion. They included Kinder Morgan, only the second exit in history to raise more than $2 billion. Aside from generating profits for private equity groups, strong exit activity in 2011 will be good for fundraising because limited partners will see returns from previous investments and be more inclined to invest in a new fund.

Conclusion
After a comeback year in 2010, the private equity industry is positioned to recover even further in 2011. Investment and exit activity will continue to build on the expansion experienced in 2010, providing limited partners with returns on previous investments and the confidence to make new investments. That, in turn, will increase fundraising, enabling new funds and even greater investment activity. Overall, there will be a much improved flow of cash through all aspects of the private equity life cycle in 2011, which will generate increased profits for private equity groups.

State of the U.S. Equity Market
By Peter LeBrun

Everything is in place for 2011 to be a great year for the U.S. equity market. Upside surprises from macroeconomic data have become a trend, and revenues and profits are stronger than expected. Even investor superstitions look promising. Historical correlations suggest a good year ahead. Overall, the equity market is one of the most attractive investment opportunities currently available.

Keeping in mind that past performance does not predict future results, two trends suggest potential for strong performance in 2011. We’ve just started the third year of President Obama’s first term. Since 1900, the third year of a president’s first term has averaged a 13.3 percent increase in the S&P 500. Eighty-one percent of these years were up years. To date, this appears to be true. The S&P 500 gained 2.4 percent in January. As many investors have heard, “As goes January, so goes the year.” Since 1945, an S&P 500 increase in January was followed by an 11.6 percent gain, on average, for the rest of the year, and 85% of these years were up years. In fact, as of March 2011, the S&P 500 has gained 5.7 percent (13.3 percent in February). The year 1998 saw the last such increase, followed by a 5 percent gain in April and 0.9 percent gain in March (however, 1998 ended with the fall of Long-Term Capital Management, erasing those gains).

The economic environment heading into 2011 is similarly positive. Retail sales this past holiday season were stronger than expected, and this trend of spending followed into January. This change in spending habits was bolstered by consumers willing to borrow more. Credit card receivables increased in December for the first time since August 2008. Overall, consumer spending is expected to rise 3.1 per-
cent in 2011. The Conference Board’s Consumer Confidence Index is up to a nearly three-year high at the beginning of February. In January, the Federal Reserve revised its projections for economic growth from 3.0 percent to 3.6 percent to 3.4 percent to 3.9 percent. The Institute for Supply Management’s Purchasing Managers Index for January 2011 was at 60.8 percent—the highest level since May 2004. Overall, the macroeconomic environment is ripe for growth and recovery.

So what does this mean for the S&P 500? As of March 2011, at a 32-month high of 1,343.01 (15.95 P/E), the S&P 500 has increased 31 percent since its July 2010 low and has doubled its March 9, 2009, intraday low of 672.88 (closing at 1,353.06 would double its closing low). This better-than-expected economic data, reports of strong earnings and revenue, and a lack of attractive alternative investments are driving investors to U.S. equities. Q4 2010 earnings in 72 percent of the 395 companies in the S&P 500 reporting earnings have beaten analyst estimates. Earnings are currently strongest for the energy, financials, industrials, information technology, and materials segments, which have seen 40 percent or more year-over-year gains in Q4 earnings. Municipal bonds are at risk of default, causing investors to pull $15.6 billion out of municipal bond funds. Money market yields are exceptionally low, and performance is weak for both precious metals and emerging markets. This congruence of factors makes the equity market extremely attractive.

Where should investors put their money? The three sectors recommended as overweight by Standard and Poor’s are industrials, information technology, and materials. These are cyclical sectors with low median FY2010 debt-to-equity ratios (DTE) of 0.50, 0.15, and 0.66, respectively. S&P expects 10-year Treasury rates to end 2011 around 4.25 percent. Therefore, low DTE companies poised to benefit from economic growth will grow in value more so than higher DTE companies. In fact, higher DTE sectors (such as consumer staples and telecom services, with FY2010 DTEs of 0.80 and 1.44, respectively) have shown year to date (YTD) total return declines in 2011. Sam Stovall, chief investment strategist at Standard and Poor’s, suggests that this trend is the result of expected increases in interest rates. He posits that it both increases the discount rate needed and will increase the cost of future earnings when debt is rolled over at higher future rates.

The best performance at the beginning of the year has come from the energy sector, which returned 11.17 percent as of March 2011. S&P initially suggested to market weight this sector. This defensive sector has benefited from strong earnings driven by increasing oil prices and fuel demand. Exxon Mobil recently released its biggest earnings in two years. Chevron’s Q4 earnings have grown 75 percent year over year. BP recently reinstated a dividend after announcing Q4 earnings had grown 30 percent. At the heart of these earnings is a combination of increased oil prices and fuel consumption. A colder-than-anticipated 2010–2011 winter also drove heating fuel expenditures 10 percent higher than initial forecasts. Retail gas and diesel prices were also higher. Standard & Poor’s expects a correction in oil prices.

In the beginning of the year, industrials outperformed the S&P 500, returning 8.86 percent through February 16, 2011. This followed a strong performance in 2010 (23.9 percent return vs. the 8.86 percent return of the S&P 500). Expected 2011 EPS growth of 13 percent, an improving global economy, emerging market sales, and worldwide infrastructure spending all suggest that industrials will continue to outperform in 2011. Industrial behemoth General Electric has returned 18 percent YTD. The information technology sector has returned 8.25 percent through mid-February. In 2010, this cyclical sector underperformed the S&P 500 (9.10 percent vs. the S&P 500’s 12.80 percent). Expected earnings per share (EPS) growth is 14 percent in 2011, which contributes to the overweight rating. This sector will be driven by a healthier overall global economy, increasing demand for smartphones and tablets, exposure to emerging markets, and the need for PC replacement (as these investments have been put off). In 2011, S&P expects to see strong internal investments, stock buybacks, dividends, and mergers and acquisitions (M&A) in this sector.

Which sectors should be avoided in 2011? S&P recommends underweighting the health care and utilities sectors in 2011. Both of these sectors are defensive and are underperforming the market (2.26 percent and 0.91 percent, respectively, vs. the S&P 500’s 6.25 percent). The largest industry within health care is pharmaceuticals. It will not be a great year for pharmaceuticals, as they face patent expirations, steep competition from generics, and weak drug pipelines. Strong emerging market exposure may help these companies, but investors should seek value elsewhere. Last year’s performance for the healthcare care sector was 0.70 percent (vs. the 12.80 percent of the S&P 500).

The utilities sector returned only 0.90 percent in 2010 (vs. 12.80 percent for the S&P 500). Expect 5 percent EPS growth in 2011, but a weak housing market and demand for cyclical stocks overall will keep utilities returns low. The worst performing sector YTD is the telecom services sector, with a pal-
Have REITs Hit the Ceiling?

While the real estate investment trust industry had tremendous performances in 2009 and 2010, investors will be cautious in 2011.

By Matthew DiStefano

REIT Overview

A real estate investment trust (REIT) is a publicly traded company that invests exclusively in real estate and mortgages. Once a REIT is established, it issues a fixed number of shares that are actively traded on the stock market. Historically, REITs have been one of the best performing asset classes available to investors. From 1990 to 2010, the FTSE REIT Equity Index, which many investors use to measure the performance of REITs, generated a return of 12.17 percent, well above the 9.14 percent and 7.68 percent 20-year returns for the S&P 500 and Dow Jones Industrial Average, respectively.1 By law, all U.S. REITs are required to pay out at least 90 percent of their taxable income to shareholders in the form of dividends. As such, REITs typically generate high-dividend income, and with their tradition of favorable capital appreciation, REITs make an excellent counterbalance to any portfolio's stocks, bonds, and cash.

A Healthy Rebound

REITs, along with almost every other investment, suffered tremendously in 2008. That year, the FTSE NAREIT Equity REIT Index posted an overall decline of 17.73 percent. Despite the substantial drop, the index bounced back the following two years. The value of REITs surged in 2009, posting a 27.99 percent gain, followed by another healthy 27.95 percent return in 2010.2 The substantial gains in 2009 and 2010 were partly due to assistance from the U.S. government. An Internal Revenue Service ruling in December 2008 gave REITs a bit of breathing room by allowing them to pay up to 90 percent of their dividends in the form of stocks instead of cash. That helped many REITs preserve funds and conserve cash for debt reduction and potential future acquisitions.3

Cautiously Optimistic

With two years of positive growth, the REIT industry is now at a very interesting point in time. According to Brad Case, NAREIT senior vice president of research and industry information, the market is at the same point it was at the end of September 2008. That is very important to investors because October 2008 marked the start of the liquidity crisis. “September 2008 was already a year and a half into the downturn that was associated with the softness in the broad economy,” Case said. “We have finally completed the recovery from the liquidity crisis, and we are just about to start the recovery from the economic downturn itself.”4 As some economists are still forecasting a second “double-dip” recession for 2011, investors are cautiously trying to predict how REITs will continue to fare. Most have adopted a neutral stance on the overall REIT market, basing their projections upon general outlook that GDP growth will be gradual, representing a U-shaped recovery, as opposed to a speedier V-shaped recovery. Following the big turnaround over the past 24 months, many would agree that the majority of REITs are trading at their proper values. Even so, some analysts feel there are a few sectors that are reasonably valued and display opportunity.

Residential

Forecasts show that the home real estate sector will continue to struggle with regard to supply and demand, and renters will remain hesitant to purchase homes.5 However, this scenario does pose a silver lining. The notion of a renter’s market bodes extremely well for REITs heavily invested in apartments. The slowdown in multi-family home construction has created limited supply and caused rental property occupancy rates to rise. Average occupancy right now in the apartment space is approximately 93 percent, indicating that landlords are in control and can effectively raise rents without the fear of losing occupancy. Typically, 92 percent occupancy is about the point at which the balance of power shifts from the renter to the landlord.6 The best apartment markets tend to be where home affordability is low relative to the rest of the country. There-
fore, well-performing apartment REITs will most likely focus on heavily urbanized areas, such as New York City and San Francisco. Of course, market conditions vary significantly between metropolitan areas, but well-financed REITs could gain local market share through capital improvements or renovation opportunities by capitalizing on the growing number of tenants looking for high-quality rentals.

Others take a slightly different viewpoint and feel that the decline in home construction may soon see its end. Combined with extremely low home-ownership rates, depressed home prices and historically low interest rates will eventually lead to a rise in home sales. Richard Anderson, a REIT analyst with BMO Capital, predicts that “the affordability math will start to work out at some point.” Anderson believes that the economy will soon get to a middle ground where mortgage companies will finally begin lending to people who want to buy homes.

Retail

While retail accounts for the largest percentage of REITs by market capitalization (26.8 percent or $66.2 billion), there appears to be less potential in retail than in the residential sector. Even with reports that the economy is on the mend, high unemployment rates still weigh heavily on consumer spending. As a result, businesses are struggling, which in turn affects the performance of retail REITs, which make money from rental income. Since retail rental rates are typically negotiated as a percentage of sales, many retailers have been able to negotiate with landlords to drive down rental rates in order to combat a decrease in company revenues.

However, all is not bad in retail. Even though consumer spending is not at a level where most would like, data have shown that U.S. consumer spending on credit cards AMEX, Visa, and MasterCard rose more than 10 percent over the past year. Elevated consumer spending, compared with 2009, and better inventory management have contributed to fewer bankruptcies and store closures than predicted for 2010. Additionally, some retail REITs, such as National Retail Properties, Inc. and Simon Property Group, have indicated they are looking for acquisitions, but only at the right price.

Industrial/Office

Many analysts see the industrial and office industry having the weakest fundamentals. This sector was on the lower end of REIT growth in 2010, generating only a 17 percent return as compared with the 46 percent return from the residential sector.

Industrial REITs posted mixed results in the third quarter of 2010, with occupancies down around 85 percent. Occupancy needs to be somewhere around 92 percent in order for the landlord to have control. In the past, industrial real estate has proven to be an “economic laggard.” Two and three years after the recession in 2001, industrial companies were still feeling the effects. Since the rebound took a lot longer than it did for other sectors, industrial property owners were forced to sell excess space and reduce rental rates. Therefore, growth in this sector is predicted to stay on par with the GDP, and by the end of 2011, analysts believe that occupancy levels will slightly rise due to limited new construction supply and tighter credit conditions.

On the office side, national occupancy is hovering around 83.5 percent. Similar to the industrial market, occupancy needs to be at or above 90 percent. Occupancy levels are expected to increase slightly in 2011, primarily benefiting from a decline in new office inventory. However, factoring in slow GDP growth, the industry likely won’t return to favorable occupancy rates until late 2012.

Health Care

Health care REITs invest directly in the real estate of hospitals, medical centers, nursing facilities, and retirement homes. Since many of these facilities rely on Medicaid and Medicare reimbursements and private pay and occupancy fees for income, the success of a health care REIT is directly attributable to the health care system. Given that health care facilities do not rely on consumer spending, travel, or job growth, health care REITs hold up very well in bad economic times. Compared with the three previously discussed sectors for REITs, health care fared the best with 2.13 percent and -11.98 percent returns in 2007 and 2008, respectively.

The outlook for health care REITs appears to be split. According to the Centers for Disease Control and Prevention, there are approximately 46.3 million (15.4 percent) U.S. residents without health insurance. Regardless of how U.S. health care reform plays out, the aging population and high number of uninsured Americans create a growing need for additional health care facilities, which can indirectly benefit health care REITs.

Conversely, some have a short-term view and are paying attention to the recent performance of health care REITs. If one compares current health care REIT share prices with their FFOs (funds from operations), health care REITs are relatively expensive. “Over the years, the price-to-FFO ratio for health care REITs has ranged from eight to 13; today, it’s about 17,” said Jeffrey R. Kosnett, senior editor of Kiplinger’s Personal Finance. Additionally, many health care REITs recently issued large amounts of new stock, indicating that management may be trying to capitalize on an overvalued share price.

Moving Forward

The overall view of the real estate investment trust market appears to be neutral. Even though some sectors do present potential, many of the fundamentals for investing in REITs appear to be weak. In a GDP growth environment of 2.5 percent, it’s hard to imagine that the real estate market is positioned for growth. Investors will have to analyze carefully on a case-by-case basis which investments offer solid, long-term return potential.
The Build America Bond Program
Was it Truly a Success or an Unnecessary Cost for Taxpayers?
By Christopher E. DiStefano

For now, the Build America Bond program is dead. After one of the worst economic recessions in U.S. history, Build America Bonds, or BABs, were a welcome boost to a weakened municipal bond market. The program expanded the appetite for state and local municipal debt and attracted scores of nontraditional municipal bond investors. For 21 months, spanning April 2009 through the end of 2010, state and local governments issued BABs at a furious pace.

To its advocates, the program was a success. BABs helped state and local municipalities as well as other public entities to lower their cost of financing for critical investments in infrastructure and public improvements. To its critics, BABs came at too high a price. State and local governments received a federal subsidy while the Wall Street investment bankers who sold the bonds lined their pockets with excessive fees. Although the bond program is now defunct, there is a push on Capitol Hill to bring it back to life.

The Program and Its Triumphs
Build America Bonds were introduced as part of the Obama administration’s American Recovery & Reinvestment Act (ARRA). The act was signed into law in February 2009 and the first BABs were issued that April. BABs were designed to help state and local governments finance the construction of vital public projects, like new roads, hospitals, and schools, with the added benefit of creating jobs. The effects of the recession had prevented government agencies from borrowing funds at favorable rates in the municipal bond market. But when BABs were introduced, they became a welcome source of low-cost municipal financing and a catalyst for a lumbering economy. BABs are taxable municipal bonds that receive a 35 percent subsidy from the U.S. Department of the Treasury on the interest paid on them. In nearly all cases, the issuer, such as a state or local municipal agency, receives the subsidy directly. The program allowed agencies to borrow at low rates compared with the traditional rates garnered for issuing tax-exempt municipal bonds. For example, the University of Virginia, a public institution and the very first issuer of the bonds, dramatically reduced its financing costs for important capital expenditures. In April 2009, the university issued $250 million of 30-year, bullet-maturity, triple-A-rated Build America Bonds. The bonds were issued at a 6.2 percent taxable rate, but because of the 35 percent direct subsidy, the university will reduce its borrowing cost by over 80 basis points when compared with similarly rated tax-exempt municipal bonds. In another case, in October 2009, the Bay Area Toll Authority issued $1.3 billion of BABs to retrofit and make the San Francisco-Oakland Bay Bridge earthquake-resistant. Because of the subsidy, the authority will pay 4.07 percent in interest over 40 years compared with the 5.5 percent in interest it would have paid by issuing tax-exempt bonds. The authority’s reduced financing costs benefit the taxpayer by averting the need for an unpopular state tax hike to fund the lifesaving bridge improvements.

From a bond-issuance standpoint, the program was also quite successful, as investors had a voracious appetite for them. From April 2009 through the end of 2010, total BAB issuance reached $81.3 billion and accounted for approximately 23 percent of all new municipal bonds issued over that time period. The large supply of new BABs issued through the municipal bond market met the demands of an expanded investor base. Since BABs were taxable, the tax structure of the investments attracted new investors who typically shied away from traditional tax-exempt municipal securities. Pension fund holders and foreign investors do not pay federal income taxes on their investment holdings, and as such, have historically not invested in municipal bonds. These unlikely investors began investing heavily in BABs because of the high quality of issuer credit and the opportunity to expand and diversify their portfolios with a new asset class.

As an aside, there were varying views on the influence that foreign investors had on BABs. In December 2010, the Federal Reserve revised its quarterly data on the foreign holdings of municipal securities going back to mid-2009. The revised numbers showed that foreign holdings of municipal debt had remained relatively flat since the end of 2008, thus countering market belief that foreign investors were gobbling up BABs at a significant pace. Contrasting this data, however, was the large number of major banks that had added municipal bond sales personnel to their foreign offices, the multitude of municipal bond tutorials prepared for foreign institutional investors, and the daily accounts of sales personnel observing a spike in foreign interest for BAB investments. Despite this discrepancy, BABs had a significant impact on the municipal bond market, and a multitude of new investors, regardless of their origin, bought plenty of them.

A State Bailout and Quick Buck for Wall Street
No government program is without flaw or criticism, and the Build America Bond program is certainly no exception. Many critics of the program have called it a government bailout, and those against BABs are now working hard to prevent their resurrection.
Senator Orrin Hatch (R-Utah), the ranking Republican on the Senate Finance Committee, has called the program “a disguised state bailout,” stating that the “bonds rightly expired at the end of 2010.” There is some merit to the senator’s words. The fact that BABs subsidized the borrowing costs of many states saddled with enormous debt and large budget deficits cannot be ignored. The state of California, with one of the worst bond ratings in the union and a looming $26.6 billion budget deficit, was the largest issuer of BAB debt. It issued $77.7 billion in BABs over the life of the program, or 21 percent of the total BAB issuance. That comes at a great potential cost to taxpayers and can be seen as a precedent and a precursor for future state bailouts by the federal government.

In many instances, Wall Street bankers reaped hefty rewards from the Build America Bond program. Investment banks that brought the new bonds to market attracted considerably high fees for BABs, significantly greater than the fees for traditional municipal bonds. In a Wall Street Journal article published on March 10, 2010, it was reported that Wall Street firms had received approximately $700 million in fees for bringing BABs to market. In another show of Wall Street’s influence, many of the BABs issued at the beginning of the program were priced far too favorably for investors. This pricing discrepancy left money on the table for issuers, increased the investment bank fees, and created near riskless profits for traders.

For example, the New York Metropolitan Transportation Authority (MTA) issued $750 million in BABs in April 2009 at a yield that enabled traders quickly to pocket a $3 million profit. To put that into context, if the MTA had lowered the yield on its issued BABs by approximately 10 basis points, the agency could have saved approximately $9 million—the equivalent of eight new subway cars. These indiscretions came at a significant cost to the issuer, ultimately leading to a waste of valuable government resources.

**Will BABs Return?**

At the end of 2010, market forces, credit fears, and a surge in BAB issuance brought the municipal bond market into turmoil. In December 2010, newly issued BABs accounted for approximately 48 percent of all new municipal debt issuance, creating an unnecessary glut in supply. Municipal bond yields spiked and prices dramatically weakened. Much of the rush in BAB issuance came in the final months of 2010, as an extension of the program was not included in President Obama’s tax-compromise agreement with Republican congressional leaders.

Municipal markets have yet to recover and, as of February 2011, the rate of bond issuance was at its lowest level in nearly a decade. New concerns of a municipal debt crisis and the rising risk of credit defaults have turned investors away from the municipal bond market. President Obama’s proposal to resurrect the BAB program and make it a permanent fixture may lure investors back. However, politicians cannot use BABs as a quick fix to prop up a distressed market or subsidize near-bankrupt state governments. Before efforts commence to restart the program, lawmakers must weigh its present costs with its future benefits. Only time will tell if the BAB program was truly a success or an unnecessary cost for the U.S. taxpayer.

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**Venture Capital**

**A Shifting Tide**

By Asif Attarwala and Mattison Ford

At the onset of 2011, venture capital (VC) found itself at a crossroads. The financial crisis has brought on leaner times for venture capitalists, as money from limited partners has dried up, leaving funds looking for cheaper, more efficient ways to allocate capital. In this brave new world, the definition of what it means to be a VC appears to be changing as well. Angel investors have taken on larger roles in funding early-stage companies, and large buyout firms have entered the market as well. While initial public offering (IPO) market has recently shown signs of life, firms with strong brands such as Facebook and Groupon have eschewed going public and spurned buyout offers, choosing instead to continue raising funds.

According to data released by Cambridge Associates in February, one-year returns at VC firms rose from 6.4 percent in Q2 2010 to 8.2 percent in Q3 2010, a sign that activity in the market appears to be picking up. However, VC is a long-term, illiquid asset class, and the previous 10 years have not been kind, as returns fell from -4.2 percent to -4.64 percent. Data from Thomson-Reuters and the National Venture Capital Association shows a slight increase in new funds raised in 2010 compared with 2009; however, the actual capital going into these funds decreased by approximately 25 percent. The numbers over a five-year period are even more...
striking. In 2005, 234 new funds were raised, with $30.76 billion in capital, whereas in 2010, 157 funds raised $12.3 billion, a 60 percent decline.

So if the capital being allocated to VC has dried up, how are funds coping? In New England, the trend appears to be toward small investments in technology companies. According to data provided by Foley Hoag’s Emerging Enterprise Center, tech investments of less than $5 million were by far the most popular among New England VCs in both early and midstage rounds. On the national level, tech continues to be the most popular allocation for VCs as well. That makes sense, as tech is traditionally less capital intensive than other traditional VC asset classes like pharmaceuticals, cleantech, and biotechnologies. Cleantech, in particular, seems to be falling out of favor among both entrepreneurs and funds. Without comprehensive climate legislation, a path to revenues for cleantech firms is uncertain. At the same time, it is unlikely that legislation will be passed until clean technology can be proven profitable. Tech firms are cheap to fund, typically reach an exit faster than other industries, and have received exceptionally high valuations in secondary markets. In an environment where VCs are strapped for cash and face an uncertain future, transactions that can be turned around rapidly inspire confidence in limited partners, allowing them to raise funds more quickly.

In recent months, the IPO window has shown signs of reopening. Several well-known firms, including Kayak, Pandora, and LinkedIn, have announced public offerings. While that is certainly a positive sign, several other notable firms have declined to go public or be acquired, and have instead gone back to VCs for more funding. In December, Groupon rejected a $6 billion buyout offer from Google, instead choosing to raise $30 million in funds from a group led by Accel Partners and New Enterprise Associates. The move was a curious one for investors, who felt that a $6 billion valuation was generous for a firm whose profitability is in question. Facebook, the star of the VC universe, continues to increase its valuation while delaying an IPO. In January, the firm raised $500 million from Goldman Sachs and a single Russian investor, raising the social media company’s valuation to $50 billion.

The Facebook deal shows that the market tides may be turning against venture capitalists. The Securities and Exchange Commission (SEC) and government regulators began to question the investment by Goldman Sachs on behalf of a number of its clients and prominent Russian Internet investor Digital Sky Technologies. SEC guidelines prevent a private company from having more than 500 investors, and as media scrutiny of the “shadow market” in private companies has increased, the SEC has considered revisiting its guidelines on private investment. More recently, JP Morgan appears to have indirectly acquired a 10 percent stake in Twitter through its Digital Growth Fund’s investment in angel investor Chris Sacca’s fund. This investment through a secondary fund of a fund is unlikely to cause a stir regarding the 500-investor limit, as the fund will be seen as a single investment vehicle, whereas Goldman Sachs is viewed as a broker between clients and Facebook shares. Nonetheless, depending on the regulator’s findings, new interpretation of the 500-investor rule could restrict future VC investment.

So what does the future hold for VC? It seems that the traditional venture capital model may become a thing of the past as angel investors, buyout firms, and other new models carve out their own niche in the market. In a world where large portions of transaction activity are $5 million technology investments, it is unclear if the large fund sizes of the past are possible. In fact, angel investment has been growing, and appears to be primed for an increase in influence if traditional VCs remain strapped for cash. At the same time, many large corporations like Intel and Microsoft have created their own VC firms, aimed at creating technologies to supplement their research and development efforts. These corporate VCs may offer a clearer path to exit than the traditional model, as stronger firms could be easily integrated into the parent company.

Novel ideas have begun to spring up in the VC market as well. One that has drawn a great deal of attention is Start Fund, a $6 million fund headed by angel David Lee, which plans to offer $150,000 to every start-up company in Y Combinator. As angels become a more influential force in the venture market, it will be interesting to see how they attempt to allocate their capital more efficiently. While angels have grabbed a share at the early stages of investment, buyout firms have begun to move to the later rounds. As private equity (PE) firms have shrunk, these firms have increasingly looked to emerging companies as investment vehicles, given their relatively lower prices and potentially higher returns. Buyout firms potentially offer new channels to an exit, as they have core competencies in spinning off large firms.

As limited partner investments have dried up, the fundamental nature of the market appears to be changing significantly. While returns have improved slightly in the last few periods, five- and 10-year returns remain unattractive. As a result, VCs appear to be changing their investment allocations, aiming for smaller technology firms that can be potentially brought to an exit quickly and at a low cost. Although the IPO window appears to be reopening, several larger VC-funded companies have declined to go public or eschewed buyout offers. Potential changes to regulation also threaten to restrict future investments by venture capitalists. The uncertainty in the market has seen angels, corporate venture arms, and buyout funds taking larger roles, calling into question the viability of the traditional venture capital model. In looking at the future of venture capital, the only certainty is that nothing is certain.
The Financial Systems of China and the United States

By Daniel Nalesnik and Jia Wen

The financial systems of the United States and China have remarkably different histories and characteristics, but they are becoming increasingly intertwined. The United States’ financial system is fully developed and is seen as the world’s premier financial market. Yet as the United States begins cautiously to pull itself out of the financial crisis, the world is watching as China sails through its ninth straight year with higher than 9 percent gross domestic product (GDP) growth. With China’s economy bypassing Japan’s in 2010 to become the world’s second largest by GDP, many economists are now eyeing the future with the question not of whether China will surpass the United States as the world’s largest economy, but when. The implications for the financial systems in both countries will be profound.

The financial markets in the United States formally started with the creation of the New York Stock Exchange in 1792 on the now-famous Wall Street. In the last 219 years, it has become the world’s premier stock exchange, working to grease the wheels of the U.S. economy with a current GDP of $14.8 trillion. However, that has not been without a few bumps in the road. Over the past 219 years, there have been 47 recessions, including the Great Depression in 1929 and the Great Recession of 2007. While the recent 2007–2009 financial crisis appears to be behind us, the economy is still dragging, with 2010 GDP growth at 2.6 percent. Nevertheless, there are encouraging signs indicating a recovery is under way: 2010 saw the S&P 500 rise 12.8 percent and the Dow Jones Industrial Average gain 11 percent. Since the bottom of the recession in March 2009, both indexes have risen more than 77 percent.

In contrast, China has maintained a 9–10 percent GDP growth rate for almost 10 years. In 2010, it recorded another 10.3 percent increase, despite a disappointing stock market performance of -15.79 percent. That performance put China just ahead of Spain and Greece, which have been trapped in the European sovereign debt crisis.

At the end of 2010, the total market capitalization of the Chinese stock market (excluding Hong Kong) was US$3.4 trillion (compared with $17.28 trillion for NYSE and NASDAQ exchanges), with a market cap-to-GDP ratio of 56.38 percent (vs. 117 percent in the United States). That is not particularly high considering the average valuation in A-shares. It indicates that the role China’s stock market plays in its economic development is still constrained compared with other market-oriented countries. The total number of companies listed on mainland exchanges (in Shanghai and Shenzhen) was 2,022 by the end of 2010, with $132.6 billion held by individual investors and $277.4 billion held by 62 mutual funds. The NYSE and NASDAQ exchanges combined had 5,095 companies listed, 252 percent more by quantity than the Chinese exchanges but 500 percent more by market capitalization.

China’s bond market value reached US$2.8 trillion by the close of 2010 (vs. US$14.1 trillion for the United States). The major borrowers of debt in China are the government, large state-owned enterprises, and primarily banks. Given these numbers, it is reasonable to conclude that China’s financial system is dominated by banks, because the main source of financing for enterprises continues to be bank loans. The ratio of total bank assets to GDP in 2010 reached 237 percent, implying the critical role that Chinese banks play in its financial sector.

China’s derivative market is still underdeveloped compared with other major economies with respect to its over-the-counter (OTC) derivatives trading volume and variety (it has only limited collateralized loan obligations, or CLOs, and currency swaps, without any CDs or interest-rate swaps). China began trading index futures in 2010, which bodes well for the long-term stability of the stock market. China has several actively traded agricultural futures, and previously had metal futures in its commodity exchanges. Index futures were launched in 2010, but government bond and foreign exchange futures are still in the experimental stage. An OTC derivative market is still underdeveloped in China because it demands highly sophisticated market players and a central clearinghouse to control risks and curb speculation. It is also worth noting that the short sale was banned in China until margin trading was allowed in 2010, although only a few qualified institutional investors are allowed to trade under a limited scale.

In contrast, the U.S. derivatives market is one of the world’s most mature, with a book value of over 20 times the entire U.S. economy. Derivatives are traded on the Chicago Mercantile Exchange (CME), which has the largest number of options and futures contracts open interest in the world. Both over-the-counter and exchange-traded derivatives markets exist in the United States, with a full 97 percent of these derivative vehicles held by the top five banks. With certain economists attributing a large portion of blame for the recent financial crisis to the relatively unregulated derivatives market, a new wave of regulations was recently passed in the United States. While unlikely to slip from becoming the world’s dominant derivatives market, the landscape in the United States will surely change in light of the Dodd-Frank Wall Street Reform and Consumer Protection Act, one goal of which is to provide more transparency and accountability to the derivatives market. Securities and Exchange Commission (SEC) Chairman Mary Schapiro stated, “This law creates a new, more effective regulatory struc-
ture, fills a host of regulatory gaps, brings greater public transparency and market accountability to the financial system, and gives investors important protections and greater input into corporate governance.” The implementation details and effectiveness remain to be seen.

In 1966, the U.S. hedge fund industry (and, indeed, the worldwide hedge fund industry) was created when Alfred Jones’s fund, which had been hedging long-stock bets while short-selling other equities, earned media-worthy double-digit returns. Despite higher management fees, sophisticated entrance requirements, and performance averages that do not consistently beat other actively managed or passive funds, the hedge fund industry has since exploded as individual investors chase higher returns with superstar fund managers. Hedge funds now employ strategies such as global macro, directional, event-driven, and relative value. While every market-savvy investor has heard of the high-profile failure of Long-Term Capital Management, most hedge fund failures close shop before they are well known publicly. That leads many investors to believe that hedge funds are, on average, able to provide a better overall return than other investment vehicles. This likely indicates that, despite increased regulation, the U.S. hedge fund industry is far from dead.

As mentioned previously, the role of China’s banking sector in the development of its economy can never be underestimated, as indirect financing is still the major source of funding for most Chinese enterprises, and Chinese people are known to be habitual savers. After the reform and opening up in China in 1978, China’s banking system gradually gained more autonomy from the central bank (PBOC), starting with the commercialization of the “Big Four” in 1995. Currently, three (ICBC, BOC, and CCB) of the Big Four banks are also among the most profitable companies listed in the Chinese stock exchanges in 2010.

Sixteen Chinese banks had gone public by the end of 2010, including large state-owned players and second-tier commercial banks. Banking reform also includes the separation of supervisory functions from regulatory bodies: Now the PBOC only implements the currency policy while the China Banking Regulatory Commission supervises banks and other related asset management companies. The underlying intention behind this move was to end the policy-directed lending in which these state-owned banks would loan out billions of dollars to state-owned enterprises without any credibility evaluation. Such behavior used to pile up a great deal of nonperforming loans on the Big Four’s balance sheets (a status known as “technically bankrupt” by their Western counterparts in 2001, when China joined the World Trade Organization, and agreed to improve its banking system asset quality gradually). In order to increase the global competency of asset management companies, the Chinese government injected billions of dollars into banks through most of the 2000s. Since then, their asset quality and capital adequacy ratio has improved dramatically. In fact, many global banks have taken action to share these Chinese banks’ profitability potential. Bank of America bought 9 percent of equity in CCB in 2005 and earned $50 billion in profit when CCB went public. HSBC, the British bank, paid for 19.9 percent of CBC’s holdings, the maximum holding for a single foreign investor in Chinese banks. That is evidence that Chinese bank debuts on the global stage have captured great attention from foreign investors.

Although the Chinese security market has developed rapidly over the past couple of years (with an astonishing increase in the number of listed companies, security brokerages, and institutional investors), it is still young and unsophisticated compared with the developed securities market of the United States. Since the establishment of the Shanghai and Shenzhen stock exchanges in the early 1990s, the Chinese financial system witnessed the implementation of a series of regulations to curb unethical and illegal behavior associated with security trading and corporate governance. In 2010, the Chinese stock market finally realized full free-floating of all stocks, marking the end of the separation between state-owned shares, corporate shares, and individual shares. With the expansion of the Chinese stock market capital and the stability of stock price volatility relative to prior years, large state-owned companies sought to go back to A-share listing instead of going public through H-shares or ADRs in the United States. These companies, such as ICBC, PetroChina, China Unicom, and Aluminum China, later became the blue-chip companies that contributed to stabilizing market volatility, and ultimately attracted close attention from foreign investors.

Following the emergence of these blue-chip companies, China pushed forward with the tradable index future (CSI 300 future) in 2010. To date, this move hasn’t proven to be as successful as the regulatory bodies had expected. That is most likely because the major players in this market are still individual investors who view futures as speculative tools. Furthermore, due to the control over the convertibility of renminbi (RMB) under the national capital account, foreign investors still have only limited channels (directly investing in B-shares, buying exchange-traded funds, or investing in QFII funds) to share the stellar growth of Chinese companies’ profits. On the other hand, the potential launch of an international board in China will allow foreign companies to be listed as A-share by means of CDRs (Chinese depository receipts). It would be another channel for foreign capital to share the growth of Chinese enterprises, as over the past 30 years, the most important type of foreign capital investment in China has been FDI (foreign direct investment) in the form of joint ventures.
Although the trading volume, market structure, and legal system in the Chinese stock market have all made considerable progress, they still have plenty of room for improvement.

First, legislative bodies still need to accelerate the revising of related laws and regulations, as insider trading and conflicts of interest are still prevalent among institutional investors. Second, the corporate governance and financial compliance of listed companies still need to be changed to comply with international codes. Third, regulatory institutions should actively engage in educating individual investors to cultivate a culture of rational investing to control speculation. Finally, the mature development of the securities market cannot be separated from the support of strong bond and derivative markets. Currently, the Chinese bond market is still in a developing phase, as government bonds dominate corporate bonds, and large banks and pension funds dominate other participants in this market.\(^\text{7}\)

In the United States, the SEC is responsible for overseeing, regulating, and enforcing laws related to the securities and financial markets. Established in 1934, the SEC was created in response to the crash of 1929 and the Great Depression that followed. Legally, it is a separate entity from the government, providing it with a platform from which it is theoretically unaffected by politics. In addition to regulating the stock market and preventing corporate abuse, the SEC is now responsible for additional laws such as Sarbanes-Oxley and the Credit Rating Agency Reform Act. All publicly listed companies in the United States must register with the SEC and provide financial statements (i.e., annual reports, 10-Ks, etc.) for investor review. Over the past year, the SEC has begun high-profile investigations into large investment firms to determine if any rules were broken during the financial crisis of 2008. As the role of the SEC continues to evolve, it will be interesting to watch how its counterparts in China regulate their domestic markets. The question will be whether China will make the same mistakes the United States has or will learn from them and progress further.\(^\text{8}\)

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**A Perspective on Europe**

**An Interview with Richard Syron**

By Anna Wascher

The year 2011 promises significant changes in Europe’s economies after a rough 2010. Financial markets across the world are warily awaiting the European Central Bank’s (ECB) next move, wondering what the PIGGS (Portugal, Italy, Ireland, Greece, and Spain) will bring in the next year, and whether the deficits across European economies are suppressible without stunting economic growth.

With America still in its worst recession since the 1930s and many parts of the world on the verge of a deeper financial crisis, I sat down with Richard Syron, ex-CEO of Freddie Mac and professor of financial crisis at Boston College, to talk about the state of the European economy and where the financial crisis is headed from a global perspective.

>> **WASCHER**: Where do you think Europe falls in comparison to the U.S. as far as the depth and breadth of the recession?

>> **SYRON**: A lot of Europe was more adversely affected than the U.S. and is also recovering at a much slower rate. Some of the issues in the Middle East could have a more detrimental impact on Europe’s recovery. European markets have proven less apt to grow with change. I would be more bullish on the U.S. markets than European markets in the next year because of this. U.S. markets are much more open as far as their financial markets and labor markets; this is especially where the EU struggles to deal with change over time. It has one currency and this impacts the labor market’s flexibility; we’ll see what will happen over the next year in Europe because of this.

>> **WASCHER**: What initiatives do you think Europe should take to affect some of these issues?

>> **SYRON**: They should do everything they can to make labor markets more flexible and spend more time creating greater coordination on fiscal policy, achieving consistency across Euro economies. The Euro region has been a central bank without a country and that poses a lot of tests to it. Next year will be just as challenging in that regard.

>> **WASCHER**: Economies like France and the U.K. have been in the news a lot recently, and there are a lot of questions as to whether they are truly heading toward recovery. What do you think the year ahead looks like for these nations?

>> **SYRON**: These economies will recover but they will recover more slowly.
There are structural issues in both nations as in the U.S. as they begin to face more competition from labor markets abroad.

» WASCHER: Do you think there will be similar effects from the recession as occurred in the U.S., or do you think their differing debt structures and fiscal policies will keep them better afloat?

» SYRON: The U.S. recession was much deeper than in many of these economies. Labor markets in these economies were much less affected. The order of recovery will most likely commence with the developing world, then Asia, the U.S., and then Europe will follow.

» WASCHER: When do you think we will see the first real indicators of a recovery, and what do you think those indicators will be?

» SYRON: Toward the end of the year we’ll start to see real signs of a recovery. Labor markets are a lagging indicator as far as signs of recovery. The first sense of recovery in the U.S. will come through in the securities market, then product markets, and then eventually labor.

» WASCHER: What do you think will be the key events in 2011 for the PIGGS?

» SYRON: They have their work cut out for them, but they have good plans in place to potentially achieve a strong recovery. Two thousand eleven will continue to be a difficult and quite trying period.

» WASCHER: What do you think the future of the euro is? Will it survive the recession or will countries resort back to separate currencies? What rate against the dollar will the euro be a year from now?

» SYRON: I think the euro is here to stay, but there will most likely be more and more of an attempt to find room for flexibility within the euro for different countries. There are enormous challenges due to the differences of underlying economies in various regions. This will reflect how the underlying economies do against the U.S. If the U.S. continues to do relatively well, then this would argue for an ultimately stronger dollar.

» WASCHER: The ECB’s head, Jean-Claude Trichet, is stepping down in October and many fear his successor will bring a more restrictive monetary policy and in turn bid up the euro. What do you think a stronger euro will mean for European economies as well as the U.S. economy?

» SYRON: I think it’s going to be a challenging period ahead. It’s hard to underestimate the impact of current events in the Mideast on oil and gas markets and Europe’s dependence on them.

» WASCHER: What would the outcome be if the euro strengthened against the dollar?

» SYRON: This would be good. U.S. manufacturers and industries would win out against European ones. But this will come down to the fundamental outlook of European growth and the belief in the strength of these economies against the U.S., and right now there is a stronger case for U.S. economic growth.

» WASCHER: With Germany on the rise, what do you think its impact will be in supporting other European countries?

» SYRON: Germany is the engine of Europe, and a strong Europe needs a strong Germany. A lot of elements in Germany, including its labor markets, have been encouraging and shown great signs, and I hope to see that continue.

» WASCHER: Let’s talk a little about the U.K. Its current deficit is at 10 percent of GDP and the new Conservatives’ and Liberal Democrats’ coalition spending cuts are hoping to bring the deficit down to 2 percent by 2014. Do you think this is an achievable goal and what will the impact of this be on the U.K. economy?

» SYRON: I think this is achievable but it will be done at a cost to their economy—that’s a substantial amount of stringency to put into an economy that is already not robust. The interesting situation for all these economies is that we need much more balance in the long run across financial policies, but how radically can you impose this in the short run because of the risk of slowing down these economies? The difficulty is how to get more restrictive fiscal policy in the intermediary run and a more forgiving policy in the short run, and this is as much a political question as it is an economic question. This is something that all nations in the developed world are going to have to face in the coming year.

» WASCHER: Should there be more time spent communicating and coordinating policies across developed economies?

» SYRON: Particularly in the realm of financial regulation, there is a lot of room for coordination and there needs to be much more regulation across markets, specifically, within bank capital standards and those types of issues. Even more so how different financial instruments will be traded. This will be a real challenge for the whole developed world if not for the world as a whole.

» WASCHER: It seems that the U.S. has taken much more tighter regulation than Europe to fix its financial markets. Do you believe that Europe will need to do the same, and what will the impact of this be?

» SYRON: Europe had some, but not all of the problems that the U.S. banks had, therefore it didn’t require the same type of reaction. But I think a lot of financial institutions that compete against each other across country borders—especially global banks—have a definite need for a coordinator approach to regulation. If you have an integrated world and an integrated economy, it will be much harder to have effective regulation if it isn’t integrated. The idea that regulation will be equal across markets is a noble hope, but the U.S. had no choice except to regulate its banks to protect its economy. Over time these issues will level out, but in the short term it creates a gap between foreign banks and U.S. banks competing.

» WASCHER: What does the year ahead look like for Europe and the U.S., and can one economy take a hint from the other and prevent another drop in economic recovery?

» SYRON: These economies have become interdependent to a greater extent than they have in the past. Although we will continue to see growth, it will be at a less than strong pace.
The post-crisis period has seen an increase in financial activity in some Latin American markets. Foreign investors have begun to demand “real” and “peso”-denominated instruments as a way of hedging against stagnant markets. At the same time, the currencies of countries such as Mexico and Chile have appreciated against the U.S. dollar, partially due to lower barriers to capital investment.

While foreign investment has certainly helped growth in the region, perhaps more important has been increased market participation by the lower classes. Microfinance institutions known as Banca Comunitaria have sprung up to serve the needs of the enormous low-income populations of Latin American countries. Lending to small-business owners or entrepreneurs who previously had no access to banking services or to finance education, these institutions have been instrumental in fighting poverty, providing a level of upward mobility only dreamed of a generation ago.

Despite the successes of microbanks, they do face some challenges, most notably the high frequency of defaults on loans not backed with collateral. Since the typical microloan client comes from a poor background and does not own a formal business, having a real or financial asset as collateral is not possible. Institutions have developed different mechanisms to deal with this challenge.

Large financial institutions, which are the principal providers of micro-

loans in the region, often simply shrug off defaults. As microloans are typically for small amounts, a well-capitalized bank can easily mitigate potential losses on these products.

However, institutions that specialize in microfinance have developed a ranking system for potential clients to aid in allocations. Lending to the “wealthiest” client among the group allows the bank to minimize its credit risk. As loans are repaid and the institution grows, it expands its client base down the rankings to include poorer individuals.

To date, microfinance in Latin America has not only been a profitable business, but also provided a means to the development of a middle class. As nations in the region continue to develop, this new class of consumers will be the primary engine of growth if actual government policies permit it. For instance, the Venezuelan bank Banesco, one of the largest financial institutions in Latin America, operating in Panama, the Dominican Republic, Puerto Rico, and the United States, began microlending several years ago. The bank has given a total of 73,369 microfinance loans in the last four years, directly benefiting 130,529 people with a default rate of only 2.16 percent in 2010. During the second half of 2010, the same institution gave 13,109 microfinance loans in Venezuela, lending some $23 million. This capital has been instrumental in developing the Venezuelan economy, which has one of the highest poverty rates in South America despite its oil production capacity. However, this success will have to prove sustainable over time in order to declare victory, given that these default rates can rapidly spike up once economic growth slows.

While the American financial system continues to struggle with credit risks, emerging markets are trying to find a way to develop and serve their societies. Microfinance has allowed these financially underdeveloped societies to find a path to sustained growth through a new type of financial risk.
During his senior year, he was accepted into Omicron Delta Epsi-
york, in 2006 with a BA in economics and a minor in psychology.
John graduated from St. John Fisher College in Rochester, New
and investment committees in evaluating and selecting offshore in-
of Latin American culture enabled her to assist treasury executives
focusing on Latin American markets. Her extensive understanding
Sonia is a full-time master of science in finance candidate at Boston
concentration is in corporate finance and hopes to continue his career in finance in investment banking
or asset management. In his free time, he enjoys ice hockey, skiing,
and fishing.
Chris graduated from the School of Journalism and Mass Commu-
nication at the University of Colorado–Boulder. He spent the fol-
lowing year as a freelance journalist in Africa and the Middle East
before entering the financial services industry. Chris spent four
years at Lehman Brothers in institutional sales, and worked briefly
in UBS’s Private Bank after the bankruptcy. Chris has focused on
managerial accounting while at BC, and will be joining the com-
mmercial leadership program at GE Capital upon commencement.
Anna-Marie graduated with a dual major in international finance
and entrepreneurship from the University of Miami in 2007. Upon
graduation, she worked as a management consultant specializing in
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co-founded the nonprofit MALAIKAFORELIFE, which distributes
free malaria medication in Tanzania. At Boston College, Anna’s
concentration is in corporate finance and she hopes to enter a career
in private equity or investment banking. In her free time, Anna en-
joys playing sports, photography, and reading.
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Sonia is a full-time master of science in finance candidate at Boston
College. She previously worked as a fixed and variable income trader
focusing on Latin American markets. Her extensive understanding
of Latin American culture enabled her to assist treasury executives
and investment committees in evaluating and selecting offshore in-
vestments for financial institutions. In her free time, she contributes
to the education of children living in low-income neighborhoods.
John Pascucci
John graduated from St. John Fisher College in Rochester, New
York, in 2006 with a BA in economics and a minor in psychology.
During his senior year, he was accepted into Omicron Delta Epsi-
lon, the International Economics Honor Society. John has worked
his entire life in a small-business setting, most recently as a man-
ger and personal trainer at the Beacon Hill Athletic Clubs. John is
currently looking to make a career switch into the financial field,
and has a dual concentration in corporate finance and asset man-
agement at BC. In his free time, John enjoys an active lifestyle: bik-
ing, running, and weight training.
Michael Lietzel
Mike graduated from Pennsylvania State University in 2006 with a
BS in economics and a minor in political science. After college,
Mike worked as an economist at the Federal Energy Regulatory
Commission, where he specialized in cost allocation of power trans-
mision infrastructure and crafting quasi-market mechanisms to
ensure adequate supply of power generation resources. Mike is cur-
cently a 2012 MBA candidate at Boston College with a specialization
in corporate finance. He is working toward a career in investment
banking or M&A advisory. In his free time, Mike enjoys the out-
doors and music performance.
Adam Banakus
Adam graduated from Vanderbilt University, receiving a BA in both
economics and mathematics. Following graduation, Adam worked
at JP Morgan Equity Research as a research assistant covering the
semiconductor capital equipment sector. Adam then leveraged his
financial background and undertook an entrepreneurial venture by
partnering to roll out multiple martial arts schools. Adam is focus-
ing his MBA in asset management, believing his financial knowl-
dge and entrepreneurial spirit are key ingredients for success.
Wei Chai
Before he started the MBA at Boston College, Chai worked as com-
pliance manager of the Agricultural Development Bank of China
(ADBC), an institution that manages $249 billion in net assets.
He was promoted to this role from senior FX asset manager, where he
managed $3 million in foreign currency assets. Prior to joining
ADBC, he was a strategic consultant at IBM Global Services. Chai
holds a master’s degree in business and enterprise from Oxford
Brookes University and a BS from Peking University in China.
Evan Petrowski
Evan graduated from Boston University in 2005 with a dual de-
gree in economics and international relations. Upon graduation,
he spent five years working for RBS Citizens (Citizens Bank) as a
credit analyst and portfolio manager for the Massachusetts middle-
market commercial lending team. As a generalist lender, he covered
a variety of industries, tracking the financial and credit risk of his
portfolio through the recent recession. At Boston College, he is con-
centrating in corporate finance.
Matt Horne
Matt graduated from Holy Cross in Worcester, Massachusetts, in
2004 with a BA in economics and a minor in philosophy. He was a
member of the Navy ROTC program and played club rugby for three
years. Upon graduation, he spent six years serving as a nuclear sub-
marine officer in the United States Navy. Matt served on board the
USS Philadelphia and completed a 2007 deployment in support of
Operations Iraqi and Enduring Freedom. At Boston College, he is a
dual MBA/MSF candidate and hopes to transition into a career in
finance in investment banking or asset management. In his free time, he enjoys traveling, skiing, and golfing.

Ralph Menzione
Ralph graduated from Plymouth State University in 2004 with a BS in marketing and a minor in economics. While there, he spent four years as a member of the NCAA varsity men’s ice hockey team. He has worked at Natixis Global Associates as an account manager analyzing performance for affiliate funds. Currently, he is pursuing an MBA at Boston College with a focus in corporate finance.

Michael Xanthopoulos
Michael is a 2012 MBA candidate in the full-time program specializing in asset management at Boston College’s Carroll School of Management. Prior to business school, he spent four years living in Washington, D.C., working for Cambridge Associates as a hedge fund performance analyst in the Arlington, Virginia, office. Michael earned a BA in economics and business and a minor in English from Lafayette College.

John Ivey
John graduated from the United States Naval Academy in Annapolis, Maryland, in 2004 with a BS in economics. Upon graduation, he spent five years as a surface warfare officer in the United States Navy, conducting anti-piracy operations, maritime interdiction, and other operations in direct support of Operation Iraqi Freedom. At Boston College, John specialized in corporate finance. He has worked for the past year as an analyst at Tully and Holland, Inc., a boutique investment bank that provides merger and acquisition advisory services to consumer product companies, where he has worked on numerous buy-side and sell-side assignments. In his free time, John enjoys all Boston sports teams, golf, fishing, and spending time with his wife and two children.

Femi Ogunjumo
Femi graduated from Edward Waters College in Jacksonville, Florida, in 2004 with a BBA in organizational management. Upon graduation from Edward Waters, he first worked as a corporate account manager for Interline Brands and then ran an independent financial services retail sales business with PrimERICA Financial Services. At Boston College, he is a full-time candidate in the Master of Science in Finance program (corporate finance track), co-chair of the Graduate Finance Association, and a mentor with Invest ‘n Kids, a tutoring and mentoring program for middle school students from disadvantaged homes. In his free time, he enjoys reading, blogging, and fitness and exercise.

Tom Gibson
Tom graduated from the University of Pennsylvania in 2007 with a BA in environmental studies with a geochemistry concentration. After graduation, he worked as an energy consultant for the Wharton Small Business Development Center and then transitioned to a mutual fund trader role at Blackrock Financial Management. At Blackrock, his duties included cash management, trade execution, and settlement. At Boston College, he is pursuing an asset management concentration and seeks a career in equity research. He enjoys golfing and fishing in his free time.

Richard Lemerise
Richard is an MBA candidate at Boston College’s Carroll School of Management, where he is specializing in corporate finance and is a director of the Graduate Finance Association. Richard holds a BS in chemical engineering from the University of Massachusetts–Lowell. Prior to attending Boston College, Richard held research and development positions with Cuming Microwave and Albany International. More recently, Richard has had an internship position at Babcock Power, working in a corporate development group.

Peter LeBrun
Peter graduated from Northeastern University in Boston in 2008 with a BSBA in finance. He has since worked in management consulting, initially as a finance/IT manager and on consulting projects involving the integration of procurement functions for a Fortune 50 pharmaceutical company. At Boston College, he is concentrating in marketing informatics and hopes to continue his career in the field of business analytics. In his spare time, he enjoys playing guitar, playing Scrabble, and reading.

Matt DiStefano
Matt graduated from Union College in 2003 with a BS in civil engineering. From 2003 to 2010, he worked as a civil engineer, focusing on low-impact site design and storm-water management for real estate development projects. He is a registered professional engineer in the state of Massachusetts. Matt’s personal interests in investing led him to Boston College to pursue a career in investment management. He will be interning this summer at State Street Global Advisors in the company’s fixed income division. Upon graduation in 2012, Matt plans to work as an equity or fixed income analyst.

Chris DiStefano
Chris is a 2011 MBA candidate in the full-time program, specializing in asset management and finance. Upon graduation, he will continue his career at State Street Global Advisors, where he currently performs credit surveillance and analysis within the company’s fixed income division. Chris holds an MS in civil engineering from the University of Illinois and a BS from Union College.

Daniel Nalesnik
Daniel is currently a dual-degree candidate at Boston College (MBA and master of finance degrees). Prior to business school, he spent a year in China studying Mandarin Chinese at Peking University (Beijing) and Fudan University (Shanghai). Before going abroad, Daniel studied finance at Harvard in the evenings for three years while working full time. He graduated from the University of Massachusetts–Amherst in 2006 with a BS in computer science. After his undergraduate studies, Daniel spent three and a half years as a financial software consultant at Galatea-Associates, LLC in Boston. In his free time, Daniel enjoys studying languages and trying to understand the dynamics of global financial markets.

Jia Wen
Jia graduated from Shanghai University of Finance and Economics in 2008 with a BA in economics. After graduation, she worked for two years as an equity analyst at SWS Research Co. (an affiliate of SYWG, the second largest brokerage firm in China). Her main responsibility involved analyzing industry trends and scrutinizing fundamental corporate information to select good companies with large upside potential for institutional investors. At Boston College, she is a finance major and plans to continue her previous career in equity research, focused on emerging markets, after graduation. In her leisure time, she enjoys reading, karaoke, and traveling.

Paul Leblanc
Paul graduated from the College of the Holy Cross with a BA in economics in 2007. At Holy Cross, Paul was a four-year member of the varsity lacrosse team and an active participant in the Big Brothers Big Sisters mentoring program. After graduation, Paul worked on the collateral management team at Goldman Sachs Asset Management (GSAM) for three years. In this capacity, Paul was responsible for monitoring the counterparty risk of GSAM’s hedge funds, mutual funds, and separate accounts. Paul is concentrating on asset management at Boston College and is looking to stay within financial services by pursuing an investment management career.
Writers/Editors

Jackie Carey
Jackie graduated from Boston College in 2003 with a BA in philosophy. Upon graduation, she worked at Goldman Sachs in New York. She received an MS in international finance in 2005 from the Institut des Hautes Etudes Economiques et Commerciales in Paris, France, where she also held a graduate internship at AXA Investment Management in the institutional product development group. After graduation, she returned to New York and worked at UBS Private Wealth Management as a financial adviser until 2009, when she pursued her MBA. Beginning at Fordham Graduate School of Business in New York, she later transferred to BC to complete her MBA in May 2011. At BC, she has participated in the Center for Investment Management Research competition to invest a portion of the BC endowment. Her team, along with one other, won this competition and is now investing these funds. Upon graduation from BC, Jackie plans to pursue a career in asset management. In her free time, she enjoys running, hiking, and skiing.

Asif Attarwala
Asif graduated from Emory University in 2009 with a BBA in finance and accounting. Upon graduation, Asif went to work as an analyst for Wells Fargo in the bank’s Atlanta corporate banking office. After leaving Wells Fargo in April 2010, he took a corporate finance position with the Henkel Corporation in Shanghai, China. At Boston College, Asif is a member of the MSF class of 2011, and plans to continue his career in investment banking or private equity. In his free time, he enjoys playing the guitar, snowboarding, and running.

Mattison Ford
Mattison graduated from Pennsylvania State University in 2008 with a BS in finance and a minor in economics. Following graduation, Mattison worked at KPMG as an advisory associate focused on risk and compliance before attending graduate school. At Boston College, Mattison is part of the 2011 MSF class pursuing a career in investment banking or private equity. In his free time, he enjoys playing the guitar, snowboarding, and running.

Editors

Anne Greene
Anne is a 2004 graduate of Vanderbilt University with a BS in human and organizational development. Her most recent position was at New Hill Management, a venture capital firm focused on commercializing advances in science from leading U.K. university spinoff companies. Previously, she worked at East Hill Management, an SEC-registered investment management firm with more than $300 million of assets under management. Currently, Anne is in the full-time MBA program at Boston College, specializing in asset management.

Thomas Latronico
Tom received a BS in biology and English from Tufts University in 2005. He then accepted a position with Liberty Mutual’s personal lines business unit, selling and servicing various insurance products. In 2007, Tom transitioned to Liberty Mutual’s commercial lines business where he worked as an analyst, designing, improving, and maintaining various business and systems processes. One of his achievements during this time was taking part in the successful implementation of a new property exposure database that enabled senior management to make better-informed enterprise risk management decisions. In 2009, Tom left Liberty Mutual to pursue his MBA at Boston College where he is specializing in brand management and marketing informatics. Tom is a licensed private pilot and enjoys flying and playing guitar.

Farida Renata Heyder
Farida has a bachelor’s degree in computer engineering from Nanyang Tech University, Singapore. She is currently a full-time student at Boston College pursuing her master’s in finance and a part-time student at Harvard Extension School working toward a master of liberal arts in journalism. Before coming to Boston, she spent three years working at JP Morgan Singapore as a market data associate assigned to all business groups in Singapore, the Philippines, Indonesia, and Malaysia. She hopes to return to Asia and take on a front-office position with an investment bank or asset management company. Farida is a scuba diver and an adventure traveler. Her last conquest was Machu Picchu and Patagonia.

Sam Subilia
Sam graduated from the University of Maine–Orono in 2009 with a BS in finance and a minor in political science. While attending college, Sam earned his living playing poker professionally. He lived in Las Vegas to compete in the World Series of Poker twice and was sponsored by Pokerstars.com to play in live tournaments in the Bahamas and Monte Carlo, Monaco. At Boston College, he is working toward his MSF degree and hopes to work in commercial banking or private equity upon his graduation. In his free time, he enjoys playing basketball.

Robin Kelly
Robin is a 2004 graduate of the University of Massachusetts–Amherst with a BA in economics and a minor in French and Francoophone studies. After spending one year at State Street Corporation, she began working at PanAgora Asset Management, Inc. While at PanAgora, Robin held roles in the operations and compliance department; for the past three years, she assisted with the development and maintenance of a program to ensure compliance with domestic and international regulatory requirements. Currently, Robin is pursuing a dual MBA and MSF in the full-time program at Boston College and seeks to establish a career in corporate finance or financial consulting.

Brian Rice
Brian is a 2011 MBA candidate specializing in corporate finance. He is a senior energy supply analyst at NSTAR Electric & Gas Corporation and president of the Boston College Graduate Finance Association. Brian holds a BS in industrial economics from Union College and has worked in several consulting roles within the energy industry.

Joseph Ritter
Joseph (Joe) has over five years of experience in the financial services industry. Before returning to business school, he was a principal in the global equity beta solutions group at State Street Global Advisors (SSgA). Prior to his role at SSgA, Joe was an officer at International Fund Services where he assisted a variety of hedge fund clients with their middle- and back-office needs. Joe graduated from the University of Pittsburgh with a BA in rhetoric and business administration. At the Carroll School, he is specializing in asset management and hopes to continue his career in the alternative investment industry. In his free time, Joe enjoys sailing, skiing, and scuba diving.

Carl Hawk
Carl graduated from the University of North Dakota in 2007 with a bachelor’s degree in business administration. After college, he spent two years in commercial real estate accounting with CB Richard Ellis in Minneapolis before coming to Boston to take on a role in the family business. At Boston College, Carl is a dual-degree candidate in business administration and finance. He hopes to continue his career in cross-functional roles with an emphasis on finance. In his free time, Carl is a licensed pilot and an avid ice hockey fan.
ENDNOTES

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