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The Blackstone Peak and the Turning of the Worms* (The Slow Motion Train Wreck Continues)

Jeremy Grantham



Last quarter I conceded that no areas of this unprecedented global bubble had yet gone hyperbolic like the internet and tech stocks did in 1999. Well now there is a candidate: the growth rate of leveraged loans. At \$545 billion globally for the first half of this year, it is running 60% up on last year! 60% rings a painful bell as that was about the price rise year over year of the aforesaid internet and tech stocks in '99. And just as press coverage in '99 was dominated by news and gossip about internet and tech companies and the leaders who ran them, so today is the news full of stories about private equity heroes and particularly the vast wealth they have acquired and the low taxes they have paid, but also the splendid parties they give. Since mergers and acquisitions, to use a quaint old term, often involve painful layoffs, this talk of vast new wealth has given plenty of ammunition to politicians and union leaders who think their members are paying the price for the wealth accumulation of others. I don't think it would be exaggerating, in fact, to say that the rest of the world, that is the real world, is getting fed up with the financial world. We make more and more money and they in round numbers do not. Where we see clever global deals, they see excessive deal profits and job losses. They see themselves paying full income tax and the billionaires of private equity and some hedge fund managers paying 10% or 15% tax. And they have a point! Just as real estate developers have to pay income tax, as opposed to capital gains tax, on property sales because it is a routine part of their stock-in-trade, surely buying and selling companies is the stock-in-trade of private equity. If it is not, what is?

Remarkably the rest of the world that grows irritated by excesses in the financial world even includes some

financial insiders. For example, a recent talk show on National Public Radio featured a successful grand-old-man of private equity criticizing the new guys at Blackstone, stating that they had lost the standards set by earlier deals in private equity. In the good old days, he claimed, private equity managers improved the acquired companies with sound long-term strategies and had real societal value that Blackstone appeared to have lost. Blackstone's focus, it was suggested, had narrowed to simply how much money could be made. Even the mother of a private equity mogul was quoted to the effect that money was the only way her son graded himself. (Whether she said this admiringly or not was not revealed!) A very powerful suggestion was that no real fundamental value was being added by the new guys. Adding to this internecine warfare, a private equity leader in Britain said 2 weeks ago that he could see no reason at all why he paid a lower tax rate than a cleaning lady! When industry leaders speak out like this against the excesses of other leaders, it is easy to believe that all is not entirely well.

We have been reminded by several writers of a prior private equity boom that ended when Saul Steinberg tried to take over the illustrious Chemical Bank of New York, one of the suppliers then of takeover funds. This was not a smart idea, but showed lots of chutzpah. In hindsight, another defining event of that cycle, from the gossip angle, was the \$2 million party at the Met for his daughter! And perhaps we have now had our own defining party for this cycle. We are certainly more into gossip, analysis of the new wealthy, and the very idea of wealth itself than we have been for 75 years or so. And the less wealthy have some genuine grievances. As we featured in an earlier quarterly

* "The Worm Turns," from *Henry VI, Part III*, "The smallest worm will turn being trodden on," is an English expression implying that the downtrodden finally snap back. It is closest to "The Revenge of the Nerds" in American.

letter, average real hourly wages in the U.S. have barely budged for 40 years while European and Japanese hourly rates have more than doubled. Income distribution around the world, but particularly in the U.S., has become more skewed toward the rich. In the U.S. it has indeed risen to levels not seen since 1929 and before that in the Gilded Age. And like readers then, we are treated to descriptions of 60,000-square-foot new houses that rival in size, if not sheer splendor, the Newport “cottages” of the Vanderbilts and Astors.

Whatever the reasons for income distribution shifting toward the rich – you’ve seen the data, it’s all about the top 1% and even the top .1% and .01% – it can always be addressed by shifts in the progressiveness of income tax. But, we have addressed it by “piling on”: we have reinforced the natural global forces that are moving more wealth to the wealthy by shifting more of the tax load to sales and income taxes of average taxpayers and away from the capital gains and dividend taxes of the wealthy. The argument for not interfering with the steady tilting of income toward the rich is that it is the natural outcome of global economics. This is completely true for the distribution of pre-tax income, but completely irrelevant for the distribution of post-tax income, which has been decided for the last 100 years or so since serious taxes began by more or less deliberate political decision. To allow the natural global drift to income concentration to remain is to cede an important societal and political decision to such vagaries as how many Chinese farmers are willing to move to town and how fast! This would be a strange way to make such an important decision. The unavoidable increase in job insecurity caused by plugging China, the developing world, and the former Communist world into the global system also has been exaggerated by the wave of deals and cost cutting. If the Chinese don’t get you, KKR will, is the union leader’s nightmare.

Well if you are rich and the natural drift of global economics is on your side, and the administration is oddly pushing in your favor too, and the working stiffs are not doing particularly well, you would be very well advised to keep your head down. And some have, but in general, no such luck! Extravagant houses, flashy parties, well-observed frenzies of art purchasing, ill-advised justifications of low taxes paid, and the nice coincidence of some very visible public offerings that have underlined the immense scale of the new wealth have all served to create an important watershed event, a defining moment perhaps of this global financial bubble. From now on we should count on

politicians bearing down on this issue. And they have a lot to get their teeth into.

It is not just that income distribution has become so much less evenly divided in the last 20 years and the tax load for the rich so much lighter than it was. Corporate taxes are also declining almost everywhere as a percentage of total taxes. Now I’m no fan of corporate tax, or sales tax for that matter. Taxes are paid in the end by human beings and corporate entities merely pass taxes on. (In the U.K., for example, Exxon collects, say, \$3 a gallon tax for the government and here in the U.S. merely \$1, but it has no effect on their return.) Corporations are driven by net returns on capital after tax. But if a society decides, for political reasons, that corporate tax looks and sounds fairer, even if it’s in fact regressive, then how odd to allow higher risk taking through higher debt to determine your tax level. It almost makes it a voluntary tax. If you have a portfolio of companies, you can keep increasing your leverage just up to the point, say, where you calculate that a small percentage will go bankrupt in a 50-year economic flood. In aggregate your interest payments increase and increase until little or no corporate tax is paid at all. And this situation is so easily fixed and so temptingly fixable in the more combative environment we have created: phase out over 5 years or so, the deductibility of debt in excess of, say, 50% of total capital. Corporate taxes will rise and overpriced private equity deals will be far less common.

Corporate tax has always been a tax on efficiency – be less efficient, make less money, and you’ll pay less tax. But now it has also become a tax on conservatism and prudence. The more reckless you are, the more you borrow, and the more interest you deduct, the less tax you pay. Not a good idea in the long run. (The more economically rational way of removing this tax on prudence, which would appeal to the other side of the political spectrum, is to simply do away with corporate tax entirely and replace it with, say, a mix of sales and income tax, with whatever progressivity is desired. With the tax subsidy on interest removed, excess leverage and silly private equity deals will be much reduced in number even more effectively than by limiting deductibility as suggested above.)

A particularly tempting target for higher taxes is the carried interest of private equity and hedge funds that pay 10% and 15% rates of tax on what is really earned income. The use of offshore funds to postpone even these lower rates is perhaps even more tempting. Given what you can read in the press in the U.S., Germany, and the U.K., these targets

will not be ignored. And what particularly bad timing this issue faces here in the U.S. with the Democrats smarting from the loss of two close elections and the new Chairman of the Financial Services Committee, Barney Frank, saddled up and ready to right as many wrongs as he can get his hands on.

As I write this, more proof that the worms have turned has been presented by the conviction for fraud and obstruction of justice of Lord Black – with a name like that it must have been obvious to the jury that he, like Darth Vader, had gone over to the Dark Side. Notable for conspicuous consumption, he was “not prepared,” he said, “to re-enact the French Revolution’s renunciation of the rights of nobility.” Wow! No wonder the “little people” are getting antsy.

The increased taxes that politicians will aim at the super-rich private equity guys may well turn out to be justified, but the bad news for us other well-heeled-but-fully-income-tax-paying-obviously-innocent bystanders is that we may get thrown out with the bathwater. Oh, what a world! What a world! The point here, in case you’ve missed it, is that the global financial bubble faces a new negative in the rapidly growing hostility of politicians and the general public. This will probably result in increased taxes on capital gains and dividends as well as redefinitions of what income really is, and may easily include increases in the top rates of ordinary income tax as well. In total this will not be good for the animal spirits of investors, which are in the end the most important input into maintaining a bubble.

To torture analogies, the global financial market seems like a giant suspension bridge with complicated engineering. Thousands of bolts hold it together. Today a few of them have fractures and one or two seem to have failed completely. The bridge, however, with typical redundancy built in, can take a few failed bolts, perhaps quite a few. And only with bad luck will some of them line up in a dangerous enough sequence to bring a major strut down. This global financial structure is far too large and has far too many interlocking pieces for weakening U.S. house prices and a few subprime issues to bring it down. No, what we have to worry about is whether we are reaching a broad-based level of financial metal fatigue in which bolt after bolt will fail with ultimately disastrous consequences. The scary part is that this global financial structure is faith based, held together by unprecedented amounts of animal spirits. If the faith starts to fail it is, “sauve qui peut” (the old cry as a ship foundered), or “every man for himself.” The Blackstone Peak argument of growing hostility to the

financial world is just the kind of slow burning negative that, with plenty of help from other negatives, can finally bring the bridge down or sink the ship.

The other persistent problem dating back to February is, of course, the slowly increasing trouble with subprime mortgages. In the fixed income markets the disease – best characterized as the questioning of previously blind faith – slowly spreads: a little widening of the junk bond spread here and a little tightening of private equity credit there. But as yet the equity market seems totally unaffected with volatile and risky stocks still making the running. Although the brontosaurus has been bitten on the tail, the message has not yet reached its tiny brain, but is proceeding up the long backbone, one vertebra at a time. The housing market also refuses to cooperate with the bulls and seems highly likely to remain uncooperative for some considerable time. Even with flat prices, mortgages roll over their honeymoon rates and are repriced by up to 2½ points, sometimes for holders who were already stretched. Steadily increasing defaults make it harder for house prices to stabilize. The inventory of unsold houses seems likely to break out above 9 months’ supply where 4 months’ would be a strong market. Yet we are told on all sides, even by the Secretary of the Treasury, that even for the subprime market all is “contained.” We have to wonder if the container, in this case, will turn out to be Pandora’s.

Additionally, the strength of the U.S. economy has been, at least temporarily, impacted by the housing weakness: first quarter growth was down to 0.7% annualized and, of the 45 countries covered by *The Economist* magazine in June, the 12-month increase of 1.9% was dead last. Global economic growth remains high but is estimated to be declining this year from the remarkable level of the last 2 years. And concern with inflation is rising: it is persistently a little higher than desired in the U.S. and the U.K. It is a lot higher in India where wages in high tech and other international services are exploding to such an extent that outsourced jobs are either jumping from India to Vietnam or the Philippines (amongst others) for even cheaper wages, or more recently returning to California because wage savings in India are no longer sufficient.

Commodity prices, led by oil at over \$73/barrel, and now agricultural prices, boosted recently by ethanol production, have either risen to new highs or stayed on a high plateau, putting further pressure on inflation. Oil and agricultural prices seem likely to be a persistent problem and in general are underestimated like many other negatives in today’s feel-good market. It is not surprising that unparalleled

global growth has created substantial pressure on commodity prices and inflation. Quite the reverse. What is surprising is how low aggregate inflation has been. If 50 leading economists had sat down 5 years ago and been told how strong global growth would be, I am sure the estimate for inflation today would have been at least 1.5% or so higher than it has actually been. It should not be at all surprising, therefore, that global inflation should start to rise, for as discussed in earlier letters, the argument that global low inflation was owed directly to millions of new Chinese workers never seemed entirely convincing to us as Chinese imports constituted only 2% of our GNP and what you don't understand should never, perhaps, be relied on. (For the record, the global impact of cheap Chinese labor is felt powerfully as its percentage of global exports rises. If a rising trade surplus causes its share to merely stabilize and not fall, most of its inflation mitigating effect disappears. In fact, if its local labor costs rise faster than productivity, as they have begun to now, then it begins to export inflation.)

And then we come to the curious case of the jump in fixed income rates. In just 3 or 4 weeks in June the 10-year bond rate jumped by 60 basis points. This was not, we are assured on all sides, caused by inflation – although a June survey of investment managers did indeed show a sharp jump where 45% of them were concerned about inflation. No, it was caused by an increase in “growth,” whatever that means. What was impressive and surprising, though, was the similar rate increase for 10-year TIPS, which moved rapidly from 2.1% to 2.8%. So we can understand some odd theories coming out. But rising TIPS means that the broad cost of capital or the risk-free rate has risen, and by a lot! This of course should cause an immediate and severe sell-off in all asset class prices as well, for in theory they are affected by changes in the real discount rate more reliably than anything else. But, in practice they did not fall, for as always the real world is merely an inconvenient special case. Indeed, emerging market equities surged in precisely the same 4-week period, gaining almost 10% against other equities. To rub it in, volatile stocks in most markets, but particularly in the U.S., beat the pants off safe stocks, thumbing their noses at any suggestion that they were impressed by the increased appreciation of risk by their fixed income colleagues. We wonder if this will come to seem like the behavior of headless chickens: the equity guys are often the last to know they're dead. But it has always seemed likely that this would be a global equity market that would die hard. (In fact I toyed with the idea, in honor of Bruce Willis's new movie and a true die-hard

market, of calling this quarterly letter, “The Live Carefree and Die Very Hard Market.”)

The argument offered for the odd strength of equities was that since the increased rates were based on growth expectations rising, and since the growth rate for stocks would rise equally to offset the rising discount rate, there was no need for lower stock prices (see Jeremy Siegel on Yahoo). The bad news here is the data are just incompatible with the conclusion. For real interest rates in a given year have a slightly negative correlation with the following year's GNP growth. Even across broader time periods – 5 and 10-year periods – there is a slightly negative correlation between GNP growth and real rates. Finally, while the interest rate increase is a fact, there is, of course, no guarantee anyway that an offsetting increase in growth will occur!

So two of the three great asset classes are having the wobbles in some of their components. First, real estate is looking rather weak here and very weak in Spain, which moved into first place in the bubble league by building more houses than France, Germany, and the U.K. combined. (And talk about headless chickens! Their stock market continues to go up despite the housing crash and construction having risen to 13% of GNP!) And second, low-grade debt, especially real-estate related but increasingly including corporate loans and private equity funding, is getting nervous. But the third great asset class, stocks, seems bound and determined to make it through this third year of the Presidential Cycle – a year that has never declined materially and should be considered the bane of short sellers everywhere.

In summary, a few more bolts in the bridge may fail, but in the end you have to bet that the bridge will hold, supported by amazing animal spirits. At least until October. Even then the fourth year of the Presidential Cycle (which begins in October) is typically a quiet year. The odds of failure rise but they probably don't become high until October 2008. At that time, a new administration with its new broom and new taxes and new antipathy to the financial world's rich, coupled with tighter credit and credit problems, we will have a very typical time, based on history, to have a bear market, and I for one am betting on it.

Today's Portfolio

In terms of current portfolio positioning, we are certainly grateful in this global drought for cheap assets that U.S. TIPS have dropped in price. Back 7 years ago when they came out yielding 4.2%, we were very heavy buyers, having decided that fair value was at most 2.7%. Now, our

equilibrium model for regular U.S. 10-Year Government Bonds is assumed to be 2.9% real. Inflation risk over 10 years is clearly not insubstantial and the removal of that risk should lower return. We cannot argue for less than a 30-basis-point discount, which would take the equilibrium yield on 10-year TIPS to 2.6%, a little below where they are today. And if pushed, 2.5% or even 2.4% does not seem unreasonable. So in recent weeks with 10-year TIPS selling between 2.6% and 2.8%, we have that rarest of rare birds, a genuinely cheap asset. Needless to say, where appropriate we have been grateful buyers. Other than this we are proposing to cash in the last (or pretty nearly the last) of our anti-risk chips late this year, and once again we urge our clients to do the same. Our last discretionary risk exposure is on emerging market equity, which has been brilliant beyond belief (see Exhibit 1) and seems on course to fulfill my 3-year-old prediction that it would sell at a premium P/E to the S&P before the cycle ends. Unlike our normally premature asset allocation moves, the dazzling fundamentals of emerging market equities have enabled us to hold our overweighting and hold it and hold it. And we still have an overweighting, but the P/E differential is down to 15%. Still, all good things must eventually come to an end.

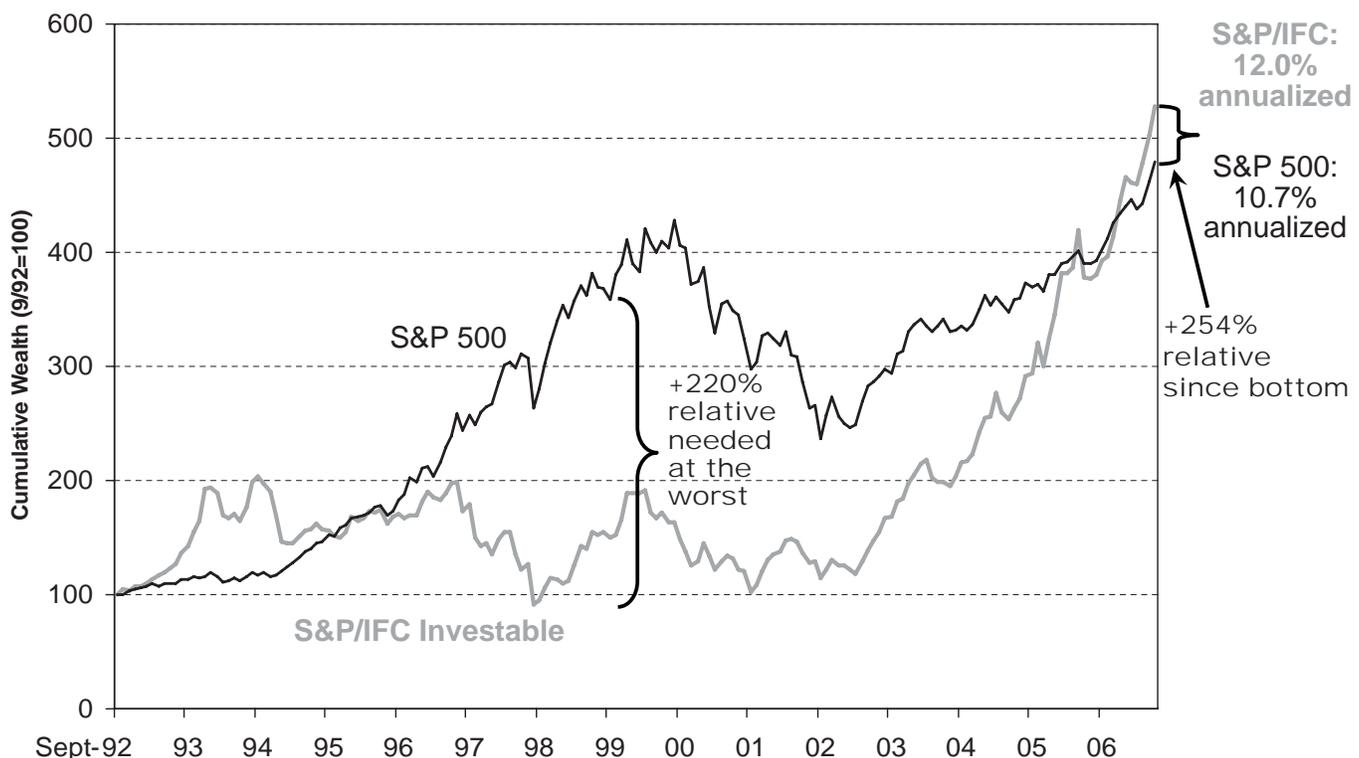
The Anti-risk Bet in Perspective: A Once or Twice in a Career Opportunity

In 40 years I believe I have been offered three obvious and extreme opportunities to make or at least save money. The first in 1974 was presented by the extreme undervaluation of small cap stocks in absolute terms – many were below 5x earnings and even more yielded over 10%. And compared to the Nifty Fifty – the great high quality franchise stocks – they were almost ludicrously underpriced.

The second opportunity was in 1999 and 2000 when the extraordinary overpricing in absolute terms of growth stocks, especially technology and the internet, meant that in round numbers everything else was relatively reasonable and some assets, notably real estate and U.S. TIPS, were simply very cheap, even in absolute terms.

Well the third great opportunity is now upon us in my opinion, and that is anti-risk. It is almost certainly the most important of the three because of its diffusion across assets and countries. That is the good news, for most of the time we have to make do with modest opportunities and this one is the real McCoy. The bad news is that for equity managers the first two opportunities were easy to spot and easy to execute. Anti-risk in comparison is a diffused and

Exhibit 1
Emerging Performance



Source: Standard & Poor's, GMO As of 6/30/07

complicated opportunity, and is as much or more in fixed income with all its new complexities as it is in equities. The ideal way of playing this third great opportunity is perhaps to create a basket of a dozen or more different anti-risk bets, for to speak the truth none of us can know how this unprecedented risk bubble with its new levels of leverage and new instruments will precisely deflate. Some components, like subprime and junk bonds, may go early and some equity risk spreads may go later. Some will prove unexpectedly rewarding and some, no doubt, will be disappointingly modest. Such uncertainties would be moderated by a complicated package approach. It will not be very easy, but some of the best hedge funds will, I'm sure, pull it off even as most of them pay the price for too much risk taking. Where we have the funds, the mandates, and

the skill we will also try our very best to capture the spirit of the exercise. To conclude, I have been trying to come up with a simple statement that would capture how serious the situation is for the overstretched, overleveraged financial system, and this is it: In 5 years I expect that at least one major "bank" (broadly defined) will have failed and that up to half the hedge funds and a substantial percentage of the private equity firms in existence today will have simply ceased to exist.

I have often been too bearish about the U.S. equity markets in the last 12 years (although bullish on emerging equity markets), but I think it is fair to say that my language has almost never been this dire. The feeling I have today is that of watching a very slow motion train wreck.*

* An exception was in the last great market aberration. In a late spring issue of *Forbes* in 2000, I debated Henry Blodget on the future of internet stocks. I argued that it was not about losing money, but survival: "80% of these companies will cease to exist."

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*Letters to the Investment Committee XII**

Evaluating the Usefulness of Private Equity Managers

Jeremy Grantham



It is generally agreed by academic researchers and informed insiders that some managers in private equity deliver real skill that increases the efficiency of companies and therefore their market value. Their skill is a scarce commodity and consequently worth a considerable fraction of the increased value, which they indeed now get. It is also generally agreed that these managers are the exception, perhaps as few as 10% or so of the private equity firms after the extremely rapid growth in the number of players. Ten years ago when the industry was a small fraction of its current size, the excellent managers were considered to be 20% or 25% of the total. Much larger are three other groups of managers: the first group adds a modest increase in efficiency, the second group nothing, and the third leaves the companies at least a little worse off than they were originally.

The disparate talents and usefulness of these managers would all be quickly demonstrated in a leverage-free world. The good managers would still be of real use to society and their clients but, even at 2% and a 20% share of profit, would make a very small fraction of what they make in today's highly leveraged world. The managers with a modest edge would only be able to charge modest fees, and the substantial majority who add approximately nothing would, in a rational world, be able to charge nothing. (But in the real world those with real talent in marketing and persuasion would be able to overcome their lack of talent in investing just as so many are able to do in regular institutional investing, which is of course a zero sum game and yet has losers charging about the same fees as winners.) But, at least to the discerning, the results in private equity would be obvious.

In private equity, the competence of individual managers is mightily confused by two different factors. First, in a world of rising corporate profit margins all managers appear to have talent for they naturally enough represent that they, rather than the broad economy, are the cause of the margin improvement. Few buyers of their services are sophisticated enough to normalize for this effect. The second confusion is caused by leverage, which raises profits and stock gains much more powerfully than real managerial skill does when times are good for credit, profit margins, and P/E multiples. When times are bad, the reverse will be true and losses will be enormous. We are led to believe that no private equity managers build in the assumption that profit margins today are abnormally high and almost certain to decline. Similarly, the probability of a broad and lengthy decline in the market's P/E structure is not discussed. Yet both are very possible and I for one believe probable.

The usefulness of increased debt – the notion that it clearly enormously increases the value of a company – is a new idea in this cycle where the premium for taking risk is either small or, as we believe, has actually gone negative: investors pay to take risk. In such a world, risk in a sense does not exist and, of course, leverage is a free good not burdened by increased risk.

In the bad old days the virtues of leverage were seen as exactly offset by increased risk. Modigliani and others argued that the debt level of a corporation did not change its value, because outside stock investors, it was assumed, could get their own debt and fine-tune it to their particular needs. These assumptions were not quite fair, or at least

* The Letters to the Investment Committee series is designed for a very focused market: members of institutional committees who are well informed but non-investment professionals.

did not accurately reflect the real world, given that the value of the tax deductibility concessions for debt, as contrasted with post-tax dividends, does not apply to tax-free institutions who have become, since Modigliani's work, owners of the majority of stock. Most institutions are also prevented by law from leveraging, while few individuals can leverage equity portfolios as highly as private equity deals are leveraged.

Another important technical advantage for private equity is that it is not vulnerable to margin calls as is a typical leveraged portfolio of traded securities. For tax-free institutions, facilitating legal leverage and capturing the tax advantage of interest deductibility is a very useful service. Obtaining high leverage is also a useful service to those taxable individuals who would like it. Obtaining leverage but avoiding the risk of the margin calls that occur with public securities is a useful service to rich individuals and institutions alike. But the legal framework is straightforward. Obtaining high debt is routine; indeed, lenders have been pressing new levels of debt and increasingly easy terms on the borrowers for the last several years of this global credit bubble. This does not require real talent as would improving the efficiency of the underlying company. It requires mere competent professionalism and as such is not a particularly scarce resource and should be available at a low service fee. One of the growing numbers of dysfunctionalities in global financial markets is that this is not the case. But at least we should not be confused by the difference between scarce talent and routine skill. Easy credit, low to negative risk premiums, rising profit margins, and high P/Es have created the opposite of the perfect storm – the perfect calm – for private equity. Extraordinary talent does not come into play except for the very best. It is the classic case of a rising tide lifting all boats. The unique aspect of this tide is how colossal the fees are and how colossally undeserved they are for the great majority of managers. And even the rare talented managers should not be charging their scarcity fees for the majority of the return that is associated with leverage.

Take-over Premium

The killer for private equity returns is the take-over premium that has to be absorbed by increased efficiency and thereby decimates (or worse) the typical true added value. The cost of the initial premiums can be, however, camouflaged by extensive leverage.

To be extremely friendly, let us assume that all managers, regardless of their talents at improving corporate efficiency, can choose companies that are selling relative to the market at a 10% discount. This is particularly friendly since value companies have just had the longest run of market outperformance in their history and low price/book proxies for value sell at their narrowest-ever range relative to high price/book companies. Selecting cheap companies, in other words, should be much more difficult than normal.

To make matters worse, the discount for perceived inefficiency is doubly overpriced because of the outperformance of low quality, inefficient companies relative to high quality, efficient companies. This quality spread is also at an all-time low. Therefore, relative to the market, inefficient companies are more expensive than normal by at least 10%. This is no doubt partly caused by investors trying to position, with some success, ahead of private equity offers.

Let us call this a draw so far, with the average manager's stock picking talent offset by a market in a mild frenzy for "value" companies and a full fledged frenzy for low quality, inefficient companies. But we still have to deal with a take-over premium to get the deal done, which appears to have averaged about 25% and has to be absorbed one way or another.

Examples of Varying Manager Efficiency in Different Economic and Financial Environments

I could not resist running through a few simplified examples of private equity deals assuming varying degrees of talent and varying degrees of favorableness in the general environment. These examples look particularly at the percent of the gain that goes to the manager relative to the client. They are in an Appendix to this letter at our website, www.gmo.com. Of course in unfavorable market conditions – the type we see as extremely likely – private equity returns will be disastrous. In the simple examples given on our website, we assume the deals must be brought back to market in 5 years even under duress. Happily for clients, this is an unfair assumption.

Caveat on the 5-year Closeout

Private equity deals, of course, do not have to be closed out in 5 years but can hang on and on, just making interest payments, renegotiating terms, selling profitable pieces, and hollowing out the firms by withholding vital long-

term spending in order to buy time. It is indeed a great advantage over the daily mark-to-market situation of public equities. But it has a huge cost: the accumulating 2% a year cost as the company limps on makes it extremely unlikely that the client will get all his money back, let alone a good profit. It is in these potentially dire market conditions that we, to our cost, think it is quite likely that real risk dominates: can these leveraged deals make interest payments in a world of lower profits and possibly higher rates and certainly higher credit standards? If their debt is light on enforcement clauses, the managers can hang on longer, hope for better times, and keep on charging 2%. If their debt has more normal provisions, they will have to hope the banks are overwhelmed with defaults and will prefer restructuring the less ridiculous deals to taking over yet another company themselves. (In that unpleasant situation the role to be played by hedge funds and CDO managers is anyone's guess.)

Manager Fees

Things to remember:

- a) The manager charges a 2% fixed fee after commitment but typically before the money is drawn down while you are usually forced to keep your money in low return cash while you wait. This is not typically factored into aggregate performance.
- b) The manager charges his full fee on that part of the return that is merely due to the normal market rise. Notably this market rise has in recent years been driven by a rising P/E and rising economy-wide profit margins that have nothing to do with manager skill. There are typically no benchmark hurdles to isolate skill. This is analogous to old-fashioned stock options that similarly flattered public company managers, but is now increasingly addressed.

- c) The manager also charges his full (and generous) value-adding fee on the return that is purely due to risky leverage, which should be available for a low service charge.

I assume this egregiously sloppy and manager-favoring fee structure owes a lot to the speed at which the industry has developed and the intensity of the desire to diversify ("look like Yale") that has created a current supply/demand imbalance. Institutions have not had time to work out quite what is going on, and are perhaps carried away by a bull market in which leveraged returns look great.

Recommendations for Dealing with Private Equity

1. Be aware that in almost all cases the combination of the starting take-over premium plus fees wipes out the effect of substantial professional talent in improving the companies, and only leverage hides this fact. Also, their fees are unjustifiably charged on market gains that have nothing to do with them and on the returns due to leverage for which you bear the risk;
2. Ask your potential private equity manager about his assumptions for future economy-wide profit margins and market P/Es, both of which are likely to decline;
3. Ask about the 2% fee in the event of very long-term work-outs, where the manager is paid to wait and pray for profits while you pay;
4. Do not budget on past private equity returns continuing;
5. If you can't get the managers with probable real alpha – it's not that difficult to prove – seriously consider skipping private equity completely; and
6. If you can't resist, then push for lower levels of leverage for future deals.

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