A NEW TAKE ON HEDGE FUNDS

Resist the temptation to lump all hedge funds into the "bad guys" category. Do your homework on each fund.

By Margo Vanover Porter

Like ice cream, hedge funds come in all sizes and flavors. "If you still think of hedge funds as a homogeneous group, you don't know enough about the mechanics, intent, philosophy, purpose, and structure of hedge funds," says Deborah Pawlowski, CEO, Kei Advisors LLC. "You have to understand hedge funds – how they are structured, why they are structured that way, what their requirements are, where the money comes from, and who earns what."

She points out that, despite their reputation, not all hedge funds enjoy high portfolio turnover. "In many cases, what I have found was that if the hedge fund managers find a story they like, they are going to be in there for the long haul," she says. "They may be on the other side of a trade at any point, but when the stock is down and you need them, they are going to be in there to buy it and help support it because they know the story."

She gives the example of a hedge fund manager she called on in California who said, "Listen, here's how I do this. Here's what my rules require me to do. I'm personally invested in all of this. I'm not a bad guy. This is just how I invest. I want to know your story because I will hang around you for 10 years. I may be long, I may be short, but I will be there a long time because I don't have the capacity or bandwidth to know a lot of different stories."

From that example, Pawlowski hopes you draw one conclusion: "This was one hedge fund's investment approach. They are all unique. A hedge fund thesis is an investment approach. You can't talk about hedge funds like it's one great big body acting homogeneously. It's not. This whole thesis about hedge funds being bad guys is outdated and over 20 years old. When are we going to get over it?"

Chris Taylor, executive vice president, managing director, global investor relations, IPREO, agrees that hedge funds are often incorrectly lumped together. "There are many different philosophies and holding periods. It's really important for IROs to understand the investment philosophy of the hedge fund, its typical holding period, and its holding period for core stocks – what we call its top 20. If you convince it to take a significant position, a major hedge fund will often be a very long-term holder. It's when they're on the fringe in terms of investing or when they haven't been convinced of the story that they can be volatile. Many have a core portfolio that is pretty stable."

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At one time, according to Taylor, a few IROs took extreme positions in their approaches to hedge funds. "The mistake they made – and I hear this less and less – is, 'I don't meet with hedge funds' or 'We meet with everyone.'"

Both approaches need refinement, he says. "Some clients hear the words hedge fund and instantly have a negative reaction. Having a catchall policy about hedge funds is a mistake. You need to do your homework on each fund. If you can't do the homework, meaning there isn't data available, then be concerned and err on the side of 'You know what? They aren't going to get my senior executive's time. I'll put them in a group and talk to them, but unless they are more transparent about who they are, what they do, and how they invest, they don't get to meet with my management.'"

Take a Targeted Approach

When interacting with hedge fund managers, "IROs should do exactly what they do when they are dealing with institutional portfolio managers who have to file their proxies with their clients," Pawlowski points out. "They should be talking with these hedge funds to figure out who they are, what their interests are, how they invest, what their holding pattern is. That's what you do: You target hedge funds just like you target portfolio managers. What you target depends on your company. What is your story? Who are your investors?"

Marj Charlier, vice president, investor relations, RealNetworks, points out that for many small high-tech companies, hedge funds are a large part of the investor base. "If we didn't talk to hedge funds, we wouldn't have many prospective investors. We have some very long-term, committed, value-and-growth investors who are hedge funds. They are not momentum players. They have long investment horizons. The myth is that all hedge funds are fast turnover, in-today, out-tomorrow players. I'm sure there are some, but the ones we talk to aren't. They're long term. They do great research. They're value-and-growth players, just like many of the mutual funds or the pension funds."

When she hears from an unfamiliar hedge fund, Charlier takes the time to investigate its turnover rate and investment style. "We're looking for high-tech investors who have a growth or value perspective because they are the types of investors who are attracted to our stock," she says. "Hedge funds are an additional buyer for your shares, and companies want as many prospective investors as they can get."

Stephen Kilmer, president, Kilmer Lucas Inc. & BioTuesday Publishing Corporation, remembers when he helped spin OccuLogix out of its parent, TLC Vision Corporation,

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in 2004. After trying unsuccessfully to reach out to traditional money managers, he decided to specifically target hedge funds.

"We talked to four or five hedge funds at a time in various cities," he says. "We started with small hedge funds and moved to larger and larger ones. Over the course of about 12 months, TLC's stock went from around $2 to about $15 because of growing investor awareness of the potential treatment for age-related macular degeneration. We then managed to spin OccuLogix out via the first successful IPO of a non-FDA-approved medical device company on a major U.S. exchange in over a decade. This is a case study of an IPO based almost entirely on marketing to hedge fund investors, as opposed to running away from them."

He reports that after the first five meetings, almost all of the rest of the meetings were generated by the hedge funds he had already met with. "Frankly, I've never seen anything like it – before or since," he says. "Our message was that we had a potential treatment for an incurable disease that ultimately results in blindness. If it was approved, it was probably worth billions. If not, it was worth nothing."

From his experience, he discovered a characteristic that separates hedge funds from traditional accounts. "One of the main differences between mutual fund or pension fund managers and hedge fund managers is the first group wants to keep it a secret what stocks they hold," he says. "They usually don't want other portfolio managers to follow their lead because they've done the work and they want to benefit from it

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FACT OR FICTION? YOU DECIDE

Through the years, hedge funds as a group have accumulated a tarnished reputation in the following five areas. Is that reputation still warranted today? You decide.

SHORT SALES. A short interest play can help mitigate market volatility, says Deborah Pawlowski, CEO, Kei Advisors LLC. "Theoretically, it should create part of the balance in the marketplace," she says. "I've seen the shorts pile on a stock and destroy them. In some cases, I've seen that not because of the company and the stock but because of the investors in the stock – long investors they are trying to drive out. It's an extremely manipulative market in many respects. But that goes to transparency and regulation, not hedge funds."

Stephen Kilmer, president, Kilmer Lucas Inc. & BioTuesday Publishing Corporation, adds that hedge funds tend to attract detail-hungry and aggressive managers with alpha personalities. "In my experience, hedge fund portfolio managers are among the best and brightest," he says. "They do their homework and have conviction, which is why hedge fund managers can be more than willing to bet that the market is wrong."

VOLATILITY. "With today's market structure and the impact of high frequency trading firms and other algorithmic types of trading strategies, a lot of folks don't necessarily look to hedge funds as the primary culprit to volatility," says Chris Taylor, executive vice president, managing director, global investor relations, IPREO. "They certainly could bring volatility to the stock, but other macro factors are impacting volatility to the extent that it's not a huge concern for many companies."

TRANSPARENCY. More and more hedge funds are reporting to the Securities and Exchange Commission, Taylor says. "Having a black hole in terms of hedge fund ownership is something that is not true any longer."

SHORT-TERM FOCUS. According to Taylor, some clients still share a common complaint about hedge funds – their conversations and questions tend to focus on the trees, rather than the forest. "They ask what's happening in the quarter, looking to get an edge that will benefit them on a trade. When you're engaging with your CFO or CEO, the last thing you want to do is put them in front of a potential investor or a group of potential investors who are focused on trying to gain an advantage from a response on a short-term subject. CFOs, CEOs, and IROs really want to talk about strategy, about the market they are addressing, about trends, about why they are going to be successful, not necessarily a short-term metric that may influence upcoming quarterly results. A lot of times – but not for all – when you get a group of hedge funds together, that's what they are clamoring for. They want something that will drive an investment idea. Unfortunately, many of those investment ideas are very short term."

SHAREHOLDER ACTIVISM. Taylor points out another concern expressed by companies. "Most of the leading shareholder activists are hedge fund managers," he says. "Folks certainly are wary of hedge funds if they're activists. They've been called the wolf pack of hedge funds because in an activist situation, hedge funds will jump into a stock to see if the lead activist will be a catalyst to unlock value."

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accordingly. In contrast, hedge fund managers see the power of demand. Once they have made the bulk of their investment, they spread the word."

Charlier echoes a similar sentiment. "Hedge funds are very communicative with us and with each other. They tend to travel in packs, or at least that's been my experience. If you attract one hedge fund, often you will attract five hedge funds – the first one and four of his friends. If one of them decides to leave the fold, you face the risk that the others will as well, which can really exacerbate a sell-off. That's the word of caution I would have."

Apt Advice

Anne Guimard, president, FINEO, believes that hedge fund managers often have a very specific way of analyzing your company, which IROs should consider incorporating into their messaging. "An IRO needs to interact with all kinds of fund managers, including hedge funds, before he or she can decide which investor profile is more likely to buy his or her company's stock and support its strategy over the long term," she says.

Other advice for interacting with hedge fund managers includes:

Get acquainted. "You have to know your hedge funds," Pawlowski insists. "Yes, there are a lot of hedge funds that behave in a short-term manner, but there are just as many hedge funds that don't. They are almost like a small portfolio manager. They can only know certain stories really well. They may have 12 to 20 stories that they hang around. They may be short or long in that story at any time, but they could hang around that story for years. Are they short-term investors? No, although they may not be in the stock long all of the time. They 'counterplay' the market. When your stock is going up, they are the ones providing liquidity for buyers. When you're going down, they may be the ones that are buying up the selling activity."

Keep your story consistent. "I am a strong proponent of matching up the audience with the message," Kilmer says. "Sometimes when you have already attracted your audience, you feel the pull to change your message. That's ultimately a mistake. You are who you are. Changing your message to appeal to a particular group is suicide. Sometimes that means you have to change your audience. Your audience can be changed, but your message has to be true."

Leverage their networks. "The best way to deal with hedge fund managers is to look at them as partners," Kilmer says. "If they make the investment and become shareholders, they have done a huge amount of work and they tend to spread the word and become a spokesperson for your company to other hedge funds. Don't be shy to ask them who else they know that might be interested in your story."

Listen. Charlier enjoys talking to hedge fund managers. "They're really smart," she says. "They're interactive. I learn a lot from them. I find it really helpful when it comes time for me to communicate with the management and board about investor sentiment because you always know what's on their mind. They communicate very well."

Take it to the top. "I believe there is value in speaking with as many constituencies as you can because of the wealth of intelligence and perceptions that you are able to gather," says Guimard. "Sometimes the dialogue is of the highest quality, and I have often found it worth bringing to the CEO level. CEOs deserve and need to be challenged in their strategic thinking, and a robust conversation with a smart hedge fund manager can be fruitful for both parties."

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Differentiate. The big hedge funds look more and more like traditional investors, Taylor says. "The industry overall is mostly institutional assets with endowment funds, public pension funds, and corporate pension funds. The money that is rolling into hedge funds is coming from stable sources. That may change the way some of the bigger hedge funds invest. Treat the larger hedge funds differently. Folks like Citadel and Maverick and other large hedge funds are investors that cannot – and should not – be ignored." IRU

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