



Active Management: Private Equity, Venture Capital, and Hedge Funds

- Moderator: **William A. Sahlman**, *Dimitri V. D'Arbeloff–MBA Class of 1955 Professor of Business Administration, Senior Associate Dean for External Relations*
- Panelists: **Paul J. Finnegan**, *Cofounder and Co-CEO, Madison Dearborn Partners Inc.*
Yoshito Hori, *Chairman and CEO, Globis Group*
Seth A. Klarman, *President, Baupost Group LLC*
Mark Nunnally, *Managing Director, Bain Capital*

Overview

A confluence of factors led to the current economic crisis, particularly the desire to achieve unattainable returns and the perception that the world was without risk. These factors led to high amounts of leverage and lack of discipline.

There will be many consequences of this crisis. The panel expects a very painful recession, potentially high inflation, and increased government regulation.

Yet, even amid these challenging circumstances, attractive investment opportunities exist. Prices are lower and private equity firms continue to have substantial sums available to invest. Patient, disciplined investors can still fare well.

Context

The panel of experienced investors discussed the U.S. financial crisis and its causes, as well as potential investment opportunities.

Key Takeaways

- **There are numerous reasons for the current financial crisis. A desire for unattainable returns, lack of an appreciation for risk, and leverage are high on the list.**

The panelists saw many root causes for the current crisis. Among them:

- *A desire for unattainable returns.* Most investors have a short-term orientation and have become obsessed with achieving short-term returns; the same applies to companies, which are focused on short-term growth. To achieve high results, investors took greater and greater risks; in doing so they didn't see their actions as risky. Most investors lacked the discipline to accept lower returns and/or to sit on the sidelines.

"Everyone was trying too hard to earn returns and didn't take risk into account."

— Seth A. Klarman

- *The compensation of those in the financial system.* There has been a disconnect between compensation and risk. People were compensated to initiate loans and sell them off, transferring the risk. The fact that the loans did not have any documentation or might be risky was of little concern to those initiating loans. This disconnect between compensation and risk existed throughout the system.

"At the heart of the problem is a disconnect between compensation and risk."

— Paul J. Finnegan

- *Lack of appreciation of risk.* The market as a whole simply failed to appreciate the risks that existed. This made money abundant and inexpensive. Mr. Finnegan provided an example that showed the lack of appreciation for risk: In June of 2007, the premium above the 10-year Treasury for the high yield index was just 240 basis points; historically it has been 540 and today it is around 800. This shows that the market failed to assign risk to fundamentally risky securities.
- *Failure of the ratings agencies.* The ratings agencies failed to properly identify the risks that did exist, leading investors to believe the risks were low.
- *The use of leverage.* Because debt was inexpensive and easy to get, all of the actors in the system took on enormous leverage. They sought to maximize their returns and didn't see risk in having significant leverage.
- *Lack of discipline.* This crisis is not just about consumer mortgages; it is about lack of discipline among all players in the system. Consumers have spent beyond their means, using home equity loans like an ATM as personal savings have gone to zero. The corporate sector has lacked discipline, as has the government.
- *Lack of adequate corporate governance.* Many boards failed to exercise proper governance. Too often board members lack the necessary knowledge or skills to serve on a board and boards often don't ask hard questions about a company's risks.
- *Inconsistent government intervention.* By intervening how and when it has, the government has sent mixed messages. This could cause some people and firms to take even more risks. There is a danger that today's government rescue will cause even greater moral hazard the next time there are economic problems.

- **The consequences of this crisis are likely to be severe.**

These experts agreed that the United States is facing a wrenching economic downturn. No one knows how long or deep this crisis will be.

"This has the makings of a very different kind of recession. It will have a significant and big shock."

— Mark Nunnally



Mr. Hori described the current situation in the United States as similar to what occurred in Japan 16 years ago. He described the sequence in five phases:

- *Asset depreciation.*
- *Banking crisis.* This is happening now in the United States.
- *Substantial decrease in consumer spending.*
- *Widespread bankruptcies.* This includes bankruptcies of large companies and could include the major auto companies. In Japan, Nissan went bankrupt.
- *Bad debt in the banking sector.*

In Mr. Hori's view a recession will definitely occur and the stock market will go down farther. Only the strong companies will survive, but they will emerge even better positioned. During the 1990s in Japan, the auto industry was comprised of nine to ten large companies. After Japan's economic downturn, only two—Honda and Toyota—were able to operate independently. The others were acquired.

"When an economy is in a recession, only the good companies can prosper."

— Yoshito Hori

Along with the series of events described by Mr. Hori, other potential consequences of the crisis include:

- *Increased regulation.* The panelists see increased regulation as a certainty. Their hope is that the regulation won't go too far. There have been significant innovations in the financial sector that have resulted in significant benefits for investors and for society. But there is a concern that regulators will say that "debt is bad" and will throw the baby out with the bath water.
- *An inflationary spiral.* While the country is currently in a deflationary spiral, due to bailouts and another big stimulus package and more government borrowing, the country risks entering into an inflationary spiral.
- *A decline in HBS graduates flocking to Wall Street.* Mr. Klarman said that the entire sequence of economic events that had been taking place, including the number of HBS grads flocking to Wall Street, "has to end."

▪ **Despite the economic downturn, investment opportunities exist.**

Although the downturn is serious, for every loser there is potentially a winner. There are opportunities for consumers and professional investors. Prudent people, with small mortgages and no loans, may be in the position to buy the house of their dreams. In the financial markets, there is a lot of mindless selling. When management gets margin calls or funds are liquidated, opportunities exist for buyers.

In the area of private equity, there is still \$250 to \$300 billion that was raised in recent years. While debt will be more difficult to come by, there is still a great deal of equity funding available. (In fact, there is still so much capital that private equity firms will have to compete with each other for deals.)

"If you look historically, recessionary periods are outstanding for returns [for private equity funds]."

— Paul J. Finnegan

For those deals that do get done, they are likely to have a longer life than in previous funds. But the hope of those in private equity is that in three to five years greater stability is expected and they will be able to exit.

Other Important Points

- **Mark-to-market accounting.** Mark-to-market accounting isn't perfect since it forces investors to mark all of their assets to the most recent market price at a specific moment in time, which may not be truly representative of an asset's true value. However, as imperfect as this method is, it is not clear that there is a better method for firms to disclose the value of their assets.



Speaker Biographies

William A. Sahlman, MBA 1975, Ph.D. BE 1982 (Moderator)

Dimitri V. D'Arbeloff—MBA Class of 1955 Professor of Business Administration, Senior Associate Dean for External Relations

Bill Sahlman is the Dimitri V. d'Arbeloff—MBA Class of 1955 Professor of Business Administration at HBS. He received a BA in economics from Princeton University and an MBA and Ph.D. in business economics from HBS.

Sahlman's research focuses on the investment and financing decisions made in entrepreneurial ventures at all stages in their development. He has written numerous articles on such topics as entrepreneurial management, venture capital and private equity, deal structuring, and the role of entrepreneurship in the global economy. He is completing work on a trade book tentatively titled *Being Entrepreneurial*, which describes lessons learned from studying hundreds of successful and unsuccessful ventures over the past 25 years. Sahlman has published over 150 case studies on entrepreneurial ventures around the world.

In 1985, Sahlman introduced a new second-year MBA elective course called Entrepreneurial Finance, which has been taken by over 8,000 students since it was first offered. Sahlman and HBS coauthor Paul Gompers published a casebook titled *Entrepreneurial Finance* in 2002. In 2000, Sahlman helped introduce and teach a new MBA course in the first year called The Entrepreneurial Manager. In 2006, he and HBS colleagues Michael Roberts, Howard Stevenson, Paul Marshall, and Richard Hamermesh published the casebook titled *New Business Ventures and the Entrepreneur*.

Sahlman is senior associate dean for External Relations and has been cochair of the Entrepreneurial Management unit (1999–2002) and senior associate dean, director of Publishing Activities, and chairman of the board for Harvard Business Publishing Corporation (1991–1999). From 1990 to 1991, he was also chairman of the Harvard University Advisory Committee on Shareholder Responsibility. Sahlman is a member of the board of directors or board of advisors of several private companies and nonprofit organizations.

Paul J. Finnegan, MBA 1982

Cofounder and Co-CEO, Madison Dearborn Partners Inc.

Paul Finnegan is cofounder and co-CEO of Madison Dearborn Partners Inc. Earlier in his career, he was with First Chicago Venture Capital for 10 years and held a variety of marketing positions in the publishing industry in the United States and Southeast Asia. Finnegan has more than 26 years of experience in private-equity investing, with a particular focus on the communications industry.

He serves on the boards of iplan LLC and Rural Cellular Corporation.

Finnegan is a member of the Harvard Board of Overseers and past president of the Harvard Alumni Association. He is also a member of the Leadership Council of the Harvard School of Public Health and the HBS Board of Dean's Advisors. He is the chairman of Teach For America in Chicago, a member of Teach For America's national board, and the chairman of the Communityworks Advisory Committee of the Evanston Community Foundation. He holds a bachelor's degree from Harvard College and an MBA from HBS.

Yoshito Hori, MBA 1991

Chairman and CEO, Globis Group

Yoshi Hori is chairman and CEO of Globis Group, founded in 1992 in Tokyo. The group has three lines of business: Globis Management School (GMS), Globis Organizational Learning, and Globis Capital Partners. In December 2005, GMS obtained a license from the Ministry of Education to award MBAs, and in April 2008, it officially became an educational corporation. GMS was ranked among the top three business schools in Japan by the *Nikkei* industrial newspaper and has become the largest business school in enrollment, with three physical campuses in Japan: Tokyo, Nagoya, and Osaka.

Hori is also a founding managing partner of Globis Capital Partners, which manages three funds: Globis Incubation Fund (1996), Apax Globis Japan Fund (1999), and Globis Fund III (2006), with a total commitment of over 38 billion yen (US\$360 million).

Hori is a member of the World Economic Forum's New Asian Leaders, a board member of Keizai Doyukai (the Japan Association of Corporate Executives), and the Japan Private Equity Association. He founded the Japan chapter of the Young Entrepreneurs' Organization (YEO) in 1995 and became the first board member of YEO International in 1996, in charge of the Asia-Pacific region. He also served on the HBS Alumni Association Board from 2005 to 2008.

Hori is the author of *Six Dimensions of Life, Personal Mission Statement, The Case-Method Approach to Strategic Entrepreneurship*, and *Venture Management Revolution*. He also periodically blogs on his Web site, *Views from an Entrepreneur*. He has been featured in the *Wall Street Journal* and on the covers of *Forbes Japan* and *Forbes Asia* as one of the most successful entrepreneurs in Japan.

Hori received a BS in engineering from Kyoto University in 1986 and an MBA from HBS in 1991. He worked for Sumitomo Corporation before establishing Globis. He enjoys swimming, traveling, and the game of Go. Most of all, he enjoys his family with his wife and five sons.

**Seth A. Klarman, MBA 1982***President, Baupost Group LLC*

Seth Klarman is the president of the Baupost Group LLC, which manages about \$15 billion on behalf of individual and institutional clients. He has had primary responsibility for managing Baupost's investments since the company was formed in May 1982. Baupost uses a value discipline with an event-driven bias to find global opportunities in such diverse areas as publicly traded and private equities, bankrupt and financially distressed debt, and real estate. Baupost's largest partnership vehicle has achieved compound net annual returns to investors of over 20 percent and has experienced only one money-losing year since its inception in 1983.

Klarman is the author of *Margin of Safety*, a book that outlines his value investment philosophy and has been featured in a variety of investment industry publications. He is a 1982 graduate of HBS, where he was a Baker Scholar. He received his BA, magna cum laude, in economics from Cornell University in 1979.

Klarman is national chairman of Facing History and Ourselves, a teacher-training organization. He is a member of the Board of Dean's Advisors at HBS, where he has been a senior lecturer on value investing and previously served as a member of the Alumni Board. He is chairman of the Klarman Family Foundation, serves as chairman of the board of directors of the David Project, and is a past annual campaign cochair for Boston's Combined Jewish Philanthropies. Klarman was born in New York City, grew up in Baltimore, and now lives in Chestnut Hill, Massachusetts, with his wife and three children.

Mark Nunnelly, MBA 1984*Managing Director, Bain Capital*

Mark Nunnelly is a managing director at Bain Capital, a leading global private investment firm based in Boston with \$70 billion in assets under management. Nunnelly co-leads Bain's North American Private Equity Practice.

Since joining Bain Capital in 1989, Nunnelly has played a leading role in such prominent consumer product investments as Domino's Pizza, Dunkin' Brands, and Warner Music Group, as well as technology companies UGS and Experian.

Nunnelly is a member of the boards of directors of Domino's Pizza, Warner Music Group, OSI, and Dunkin' Brands.

Prior to joining Bain Capital, Nunnelly was a vice president of Bain & Company, with experience in its domestic, Asian, and European strategy practices. Previously, he worked at Procter & Gamble in product management.

Nunnelly is an active supporter of several charitable organizations, serving as a member of the boards of directors of New Profit Inc. and Jump Start. He has also been actively involved with City Year, a national youth service corps, since its founding. He serves as a trustee for the Boston Medical Center, the Museum of Science, and Centre College.

Nunnelly received an MBA with distinction from HBS and a BA from Centre College.