White Paper

December 2008

# True Alpha – Does It Exist?


## Executive Summary

Traditionally, investors have focused on portfolios consisting of the three primary asset classes: stocks, bonds and cash. Many financial models often recommend allocations to non-traditional asset classes and strategies that have a low correlation to the market. Although a number of these strategies failed to deliver under the extreme stress test of 2008, alpha can still be found in a number of strategies. As investors prepare to reposition their portfolios, absolute return strategies with genuine sources of alpha should be part of the equation. But investors and advisers seeking this alpha should be careful to only select strategies that are easy to understand, are capable of generating absolute returns without the benefit of leverage, provide diversification and low correlation to the stock market, are transparent and, if at all possible, are packaged in the form of liquid investments.


KEATING INVESTMENTS

*Some bursars will buy without a tremor unquoted and unmarketable investments in real estate which, if they had a selling quotation for immediate cash available at each audit, would turn their hair grey. The fact that you do not know how much its ready money quotation fluctuates does not, as is commonly supposed, make an investment a safe one.*

--John Maynard Keynes, "Memo for the Estates Committee, King's College, Cambridge" May 8, 1938

John Maynard Keynes was the economist who reminded us that the market can stay irrational longer than we can stay solvent (actually the good news), and that in the long run we are all dead (the bad news). During 2008, a lot of money managers have been thinking about Keynes' insights, perhaps no one more so than Bill Miller of Legg Mason.

## The End of Mutual Fund Alpha

In every year from 1991 to 2005, the Legg Mason Value Trust managed by Bill Miller outperformed the S&P 500 index. It was an unprecedented winning streak that earned him Morningstar's fund manager of the year in 1998 and then the fund manager of the decade award the next year. After having a white hot hand for 15 years, Bill Miller turned stone cold in 2006 and 2007. Then the Legg Mason Value Trust simply imploded in 2008, losing 65% of its value—or 27% worse than the S&P 500. According to Morningstar, the Legg Mason Value Trust is now among the worst in its class for the last one-, three-, five- and 10-year periods. In fact, the Legg Mason Value Trust ranked dead last in 2008 for non-leveraged U.S. stock funds with over $100 million in assets. Talk about reverting to the mean! The poster child for alpha in the mutual fund industry just crashed and burned.

The mutual fund industry's underperformance relative to the market has been well documented in the academic literature over the last 30 years. The explosion of passive investing and indexation in the 80's and 90's in reaction to both academic theory and the returns experienced by the investing public is Exhibit A in the case against active equity management. If not in long equity strategies, then whence to go in search of that elusive alpha? Yale University is a good starting point to begin our quest.

## Yale Makes the Case for "Absolute Return"

The Yale endowment's impressive investment performance over the past decade, including a return of 28 percent in the fiscal 2007, has understandably created significant interest in understanding the keys to that outsized performance. Upon joining Yale in 1985, Chief Investment Officer David Swensen began taking steps to modernize the endowment. He began by shifting funds from cash and U.S. securities toward tangible assets such as timber, fuel and real estate. He also earmarked more money for buyout funds, and added a new asset class that Swensen dubbed "absolute return."

The goal of absolute (or "alternative investment") strategies is to always produce a positive absolute return regardless of the directions of financial markets. The classic example is a long-short hedge fund strategy. In addition to the goal of always producing positive returns, the second objective is to lower risk by having strategies with low correlations to the market.

Swensen's pioneering foray into alternative investments has helped increase the Yale endowment from $4 billion to over $22.5 billion in the past decade, generating an average annual return of 17.8 percent along the way. A significant portion of that return is attributable to Yale's outsized exposure to alternatives.

Today, alternative investment strategies come in many flavors: hedge funds, venture capital, private equity, real estate and commodities, among others. The common theme is that there are greater inefficiencies in illiquid assets. Investors are compensated for the illiquidity with higher returns. Of course, too much of anything—including illiquid investments—can be a bad thing. To see the other side of the coin, let's take a trip from Yale to Harvard.

## Harvard Gets a 50 Cent Bid on Its Private Equity Interests

The Harvard-Yale rivalry is legendary, in all things from the number of Nobel laureates to United States Presidents. While Harvard's football team recently beat Yale 10-0 in the 125th playing of "The Game", there is nothing to brag about in Cambridge these days based on recent troubling reports from the University's endowment. During the first four months of the 2008 fiscal year, the Harvard University Endowment suffered losses of 22%--or $8 billion in real money. Moreover, Harvard warned that losses could run even higher once it factors in some of its illiquid investments such as real estate and private equity. Consider the following:

> *Harvard's loss marks a sharp reversal from the endowment's formerly chart-topping performance. Harvard and Yale University -- which hasn't disclosed its endowment's recent performance -- pioneered an investment approach that de-emphasized U.S. stocks and bonds and placed large sums in more exotic and illiquid investments, including timberland, real estate and private-equity funds. That strategy, which was widely copied, helped the schools avoid significant losses after the technology boom ended in 2000.*
>
> *But the current market has been far less favorable, partly because both Harvard and Yale have relatively small holdings of bonds, such as U.S. Treasurys, one of the few assets that have performed well. Harvard began its fiscal year with a target of having 33% invested in publicly traded shares, split among U.S. stocks, which have dropped 24% in the four months through October, and international stocks, which have fared worse.*
>
> *Other investments, such as commodities, which were a boon to Harvard in past years, have turned negative in recent weeks. Harvard has sought to sell off about $1.5 billion in investments with private-equity firms, which typically use their assets to fund corporate takeovers, according to people familiar with the situation. That would be one of the largest sales ever of a private-equity stake.* ***But its private-equity partnerships received bids of only around 50 cents on the dollar****, say other people familiar with the matter. -- The Wall Street Journal*, December 4, 2008

Unfortunately, Harvard has plenty of company in this department. Most managers of alternative investment strategies—be it of the hedge fund, real estate, venture capital, or private equity variety—have had a brutal 2008. These strategies have been put to the most severe test yet in their relatively short history and have generally failed both the positive return and low market correlation tests. Which begs the question: does true alpha exist? We submit that the answer is an unqualified yes, but that one has to

look very hard to find it. As one case study, we will examine a specialized private equity strategy that makes pre-IPO investments. Let's begin with Private Equity 101.

## The Bull and Bear Cases for Private Equity

First, the bull case. According to the Private Equity Council, "During the 25 years from 1980 to 2005, the top-quartile private equity firms generated annualized returns to investors of 39.1 percent (net of all fees and expenses). By contrast, the S&P 500 returned 12.3 percent during the same period. This suggests that $1,000 continuously invested in the top-quartile PE firms during this 25-year period would have created $3.8 million in value. The same amount invested in the public markets would have increased to $18,200."

On the other hand, Larry Swedroe and Jared Kizer, authors of *The Only Guide to Alternative Investments You'll Ever Need*, make the bear case. They cite a study that shows that the average private equity fund beat the S&P 500 by 3%--before fees and expenses. After fees and expenses, the 3% positive alpha drops to a -3% negative alpha.

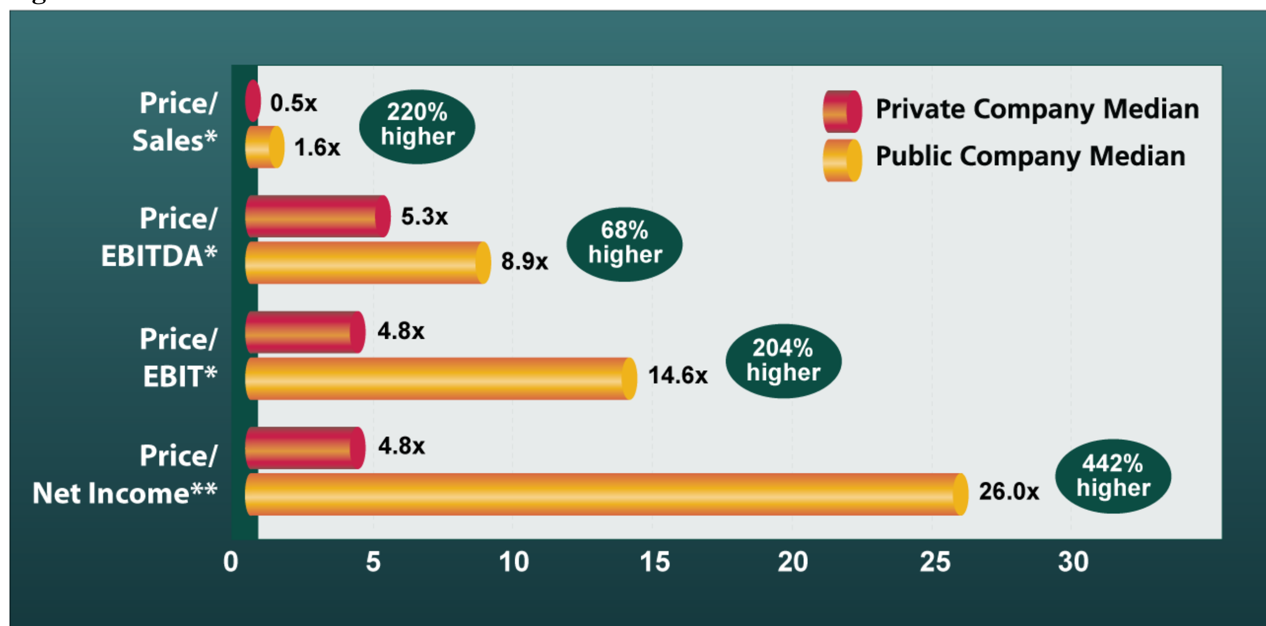
Going back to the bull case with the top quartile group, what exactly is the source of that alpha? Proponents of the private equity model point to improved company performance as the main factor driving returns. This improvement comes from a variety of sources: the addition of new products, increased competitiveness through waste reduction and improved operations, and finally growth in revenues from new markets and new customers.

Critics of the private equity model point to financial engineering in the form of levered balance sheets as the real driver of returns. Since credit for large leveraged buy outs has now vanished, the private equity world will now be under a microscope. In the next few years, we should have a clear verdict on whether the alpha in private equity comes from improved operations or leverage.

## True Alpha *Does* Exist

The goal of adding any asset to a portfolio is to make it more efficient by producing a higher return for lower risk. The first test of the alternatives world, and the real challenge, is to identify market inefficiencies that systematically produce higher returns. Ideally, these inefficiencies should be large enough so that a strategy exploiting them is capable of generating a meaningful amount of alpha without the use of any leverage. One such anomaly is the valuation differential between private and public equities. The chart below illustrates this valuation differential for companies with market capitalizations/enterprise values under $100 million.

**Figure 1**




*Source: Pratt's Stats® at BVMarketData.com, Public Stats™ at BVMarketData.com as of June 5, 2008 for transactions between January 1, 2003 and December 31, 2007. Used with permission from Business Valuation Resources, LLC.*
**Valuation data based on a combined total of 4,900+ U.S. based private and public company transactions under $100 MM.*
***Keating Investments, LLC calculation based on those companies having positive net income, valuation data based on a combined total of 3,600+ U.S. based private and public company transactions under $100 MM.*

Why does this valuation differential exist? In a word: liquidity. Investors are willing to pay a significant premium for the ability to sell stock quickly.

Historically, this private-to-public arbitrage was easily exploited by investors making pre-IPO investments. A standard page from the Wall Street playbook is to raise $10-50 million in bridge financing as a means to dress up an issuer's balance sheet before beginning the IPO road show. Here's how the game works: The issuer (flush with cash from the bridge financing) markets itself from a position of impeccable balance sheet strength to go along with its future earnings capability, and—voilà—the IPO is oversubscribed and ultimately closed successfully. Post closing, the stock runs up 10-20% and the bridge investors sell into the demand. Everyone goes home a winner.

Everything was working well until about 2000—when the IPO market seized up for about three years. During this time, micro-cap IPOs (those raising less then $25 million) disappeared. Then, after a tepid revival from 2004-2007, the IPO market came to a grinding halt in 2008.

## The IPO Market

Consider these sobering facts. Through November 30, 2008, there have been 29 IPOs in the U.S. compared to a total of 210 IPOs for all of last year. Last year, the average size of an IPO was $230 million. If you exclude the $18 billion Visa IPO, the average offering size this year is $212 million; including Visa the number balloons to $800 million. In fact, there have only been two IPOs in the U.S. so

far this year that have raised less than $25 million compared to an average of nine such transactions annually for the period 2000 to 2007.

According to *The Wall Street Journal*:

- *It's official: The U.S. IPO market has seized up completely, with a record-setting stretch of inactivity that began in August. It's been 10 weeks since a company has held an initial public offering in the U.S., the longest period on record since Thompson Reuters began tracking deals in 1980.* –October 20, 2008

- *In the third quarter, only five companies raising a total of $935 million went public through IPOs in the U.S. That is down from 39 that raised $12 billion a year ago. There were only two venture-backed IPOs in the quarter…Having two venture-backed deals in a quarter isn't normally notable, but it follows a second quarter in which none appeared. That absence of –deals—the first such occurrence in three decades—spurred the National Venture Capital Association to declare a "capital-market crisis for the start-up community*." – September 15, 2008

## Capturing Alpha through an Alternative to a Traditional IPO

Although the traditional IPO market is non-existent, today there are a variety of ways that companies can and do go public in the U.S. as alternatives to traditional IPOs. One increasingly common method is a going public process through the filing of a registration statement under the Securities Act or the Exchange Act. Under this "self-filing" process, an issuer raises capital privately and then simply voluntarily elects to become a publicly reporting company. The second step of the process is for the company to seek an exchange listing and become a publicly traded company. Because there is no "public" offering of securities (as is the case of an IPO), the issuer is able to bypass the traditional IPO underwriting process altogether.

The pre-IPO investor is able to capture the same significant private-public valuation differential as before. The process just takes a little longer. Because the strategy hinges on buying at a discount to comparable public companies, low valuation environments provide an added boost to return assuming that valuation multiples eventually revert to the mean. Provided the discount is large enough (for example, 50%), the gain from multiple expansion alone would be profitable in nearly all market environments—including the current one.

Let's take a look at an example. Using the data from Figure 1 above, the median Price/EBITDA multiple for acquisitions of private companies under $100 million in enterprise value was 5.3x. For acquisitions of similar sized public companies, the multiple rises to 8.9x—a premium of 68% (the lowest of the four examples listed). To keep the math very simple, let's assume that a pre-IPO investor is able to realize this 68% return over the course of two years by investing in a company that goes public through the self-filed registration statement described above and selling the stock in the open market. This works out to a compounded return of roughly 29.6% on a completely unlevered basis.

In 2007, there were more companies that went public by non-traditional means than through traditional IPOs. Not all of them involved financing transactions, but a significant percentage did. In short, this private-to-public valuation arbitrage strategy is one example of an identifiable, quantifiable, realizable source of alpha that is generating positive returns for investors today.

## Conclusion

Traditionally, investors have focused on portfolios consisting of the three primary asset classes—stocks, bonds and cash. Many financial models often recommend allocations to non-traditional asset classes and strategies that have a low correlation to the market. Although a number of these strategies have failed to deliver under the extreme stress test of 2008, alpha can still be found in a number of strategies. As investors prepare to reposition their portfolios for a potential rebound in 2009, absolute return strategies with genuine sources of alpha should be part of the equation. But investors and advisers seeking this alpha should be careful to only select strategies that are easy to understand, are capable of generating absolute returns without the benefit of leverage, provide diversification and low correlation to the stock market, are transparent and, if at all possible, are packaged in the form of liquid investments.

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Keating Investments, LLC is a Denver-based SEC registered investment adviser founded in 1997. The firm is the investment adviser to Keating Capital, Inc. (www.KeatingCapital.com), a publicly reporting Business Development Company that is an equity capital partner for select private businesses that are primed to become public companies. Timothy J. Keating is the founder and President of Keating Investments. Previously, he held senior management positions in the equity and equity derivative departments of Bear Stearns, Nomura and Kidder, Peabody in both London and New York. He is a 1985 *cum laude* graduate of Harvard College with an A.B. in economics. He can be reached at (720) 889-0131 or at tk@keatinginvestments.com.