

Overview

Until fairly recently, a principal objective of shareholder identification and the vetting of incoming investor inquiries in the everyday investor relations process was to detect and weed out the hedge funds. Public companies—and indeed investor relations practitioners—deemed these investors illegitimate because of their potentially disruptive investment strategies, and avoided taking their phone calls, requests for meetings and questions on quarterly conference calls. No more, and not for some time: hedge funds have not only become a force to be reckoned with, they are now a primary investor constituency for all public companies, and are becoming *the* primary institutional audience for micro- and small-cap stocks. This discussion examines this fact of current public company life, and provides some guidance on how LHA’s clients can adapt.

For your ease of reading, the topics covered in this discussion include:

- I.** Proliferation—Why?
- II.** Hedge Funds as a Primary Audience for Micro- and Small-Cap Stocks
- III.** The Hedge Fund Pecking Order, and How it Helps the Micro- and Small-Cap Food Chain
- IV.** Current Regulation
- V.** LHA Analysis and Practical Impact

I. Proliferation—Why?

There are several reasons for the marked evolution in the role of the hedge fund and in the proliferation of these risk-oriented institutions.

First, there is the performance. For most of the past 15 years, the most successful hedge funds have outperformed less risky investment strategies because they could (theoretically) make money in any market. During 1990-1999, the top 25% of hedge funds beat the top quartile of traditional fixed-fee investment firms. Overall, hedge fund performance has dampened a bit in recent quarters, though this hasn’t hurt inflows, probably because of the difficulty in delivering above-average returns in recently flat markets.

Second, there are sheer numbers. Hedge funds now run an estimated \$1 trillion in managed and private account assets, quite small compared to \$7.5 trillion invested in mutual funds, but growing at a very rapid pace. From 1994 to year-end 2003, the number of hedge funds more than doubled from over 3,000 to about 6,500, and now number about 7,700. In same period, net new assets flowing into hedge funds exploded from about \$7.5 billion to over \$72 billion; in the second quarter of 2004 alone, inflows reached \$43.3 billion, up 13.4% *sequentially*, with the long/short, event-driven, and global macro styles accounting for half of this increase. These flows, representing in large part funds from professional investors such as pension funds, endowments and insurance companies, serve to legitimize the product. It is very telling that JP Morgan has purchased Highbridge Capital and that Lehman Brothers is reportedly in discussions with UK-based GLG Holdings; these are likely to serve as case studies for other traditional firms. Further, because of their risky investment strategies, hedge funds also tend to experience a higher attrition rate than that of traditional institutional funds, with new hedge funds being created as the outliers die off.

Third, there are structural trends on Wall Street that have contributed to the growth of the style. Increased regulation has made certain investment community job titles less lucrative and enjoyable. This and industry consolidation have both contributed to established professionals going out and

starting up hedge funds. There is the lure of high incentive manager fees, and it is easy to start a hedge fund with a relatively small investment. So, smart, already successful money managers and sell-side analysts with good brand franchises probably have access to capital to start a fund in which shared profits are generated from a creative investment strategies governed by less regulation: fun!

II. Hedge Funds as a Primary Audience for Micro- and Small-Cap Stocks

Constituencies that were once obvious marketing targets for smaller public companies simply aren't as available as they once were.

- Traditional investment managers continue to increase their minimum market cap requirements for investment, some of them eliminating entire echelons of market cap from their radar screens. Anecdotally, micro-cap stock minimum thresholds are now considered to be roughly \$500 million, up from \$250 million, with those of small cap stocks being \$750 million to \$1 billion.
- Further, the trend among many mutual funds is toward a preference for more stable returns, again reducing exposure to smaller cap investments because of their inherent higher volatility.
- Additionally, recent regulation has increased the burden on retail brokerages to protect the individual investor and created an opportunity for retail investors to seek redress should an investment go wrong. This has induced brokerages to protect themselves from liability by limiting the conditions under which their retail brokers can recommend stocks to clients, placing restrictions according to analyst coverage (which as we know is already limited), price per share, and market cap, and creating a prohibitive administrative task of due diligence for brokers to undertake in order to circumvent these restrictions. Therefore, many high net worth brokers who once took interest in and could maintain trading velocity in smaller companies simply can no longer do so, being restricted to a proscribed pool of stocks.
- Hedge funds are more likely than their traditional fixed-fee counterparts to be able to trade less liquid issues and can also trade more easily in and out of investments because of non-restrictive trading policies. Indeed, today hedge funds number increasingly among sell-side analysts' biggest clients, who need to keep feeding them ideas in order to win the trading revenue upon which their compensation is now based. It is also in the hedge fund's best interest to find the undiscovered story and get into the stock early.
- Hedge fund managers are known advocate stories they invest in to their own network of contacts, which contributes to a viral marketing swell that can be very beneficial to low-cap stocks, as we discuss further in section III below.

This all leaves today's hedge fund as perhaps *the* primary low-cap and early stage public equity investor.

III. The Hedge Fund Pecking Order, and How it Helps the Micro- and Small-Cap Food Chain

Everyday, we at LHA discover new hedge funds popping up in the course of our marketing efforts on behalf of our clients. These investors can be hard to track, as the majority operate with less than \$100 million in assets, the threshold required to file a Form 13-F stock ownership filing. Noticing hedge fund managers' propensity to recommend that we call upon their other hedge fund contacts to market a particular story, we engaged a few in discussion about this high referral rate. Here's what we learned anecdotally about hedge funds' pecking order and how they invest:

- There are three unofficial tiers of hedge funds: small, mid-size, and large. The larger they are, the longer they have been in business adding investment assets, and the more likely they are to have amassed a sufficient track record to qualify for investment by the funds of funds.
- The small hedge funds tend to concentrate on undiscovered stories. Once they find a story they like, they promote it to the next tier up, the mid-size hedge funds. Similarly, once the

mid-size hedge funds become comfortable with that story, then they promote it to the large hedge funds who in turn promote it to their contacts at fixed-fee institutions. Therefore, in theory, by the time an old-line institutional investor becomes interested in the story, it is possible that three hedge fund investment cycles have already taken place, with the hedge funds now exiting the issue.

- Hedge fund managers also maintain strong contacts with sell-side analysts, who are aware of this hedge fund grapevine and of the implications for their own trading revenue generation.
- Therefore, a company that has won the support of a well-connected hedge fund manager and consistently performs well fundamentally could wind up with strong stock performance characteristics including healthy trading volume, robust cycling of institutional investors, and solid “buzz”, all because of one hedge fund manager.

IV. Current Regulation

Until now, the SEC has not as comprehensively regulated hedge funds as it has investment companies. Because of the rise of the hedge fund as an investment vehicle by professional investors, and their historical reputation for shorting, day trading, and the trend toward investor protection, this is changing. The Commission is now proposing for comment a new rule and rule amendments under the Investment Advisers Act of 1940 that would require registration with the SEC in order to provide hedge fund investors the same protections afforded by the Advisers Act as other investors and to “enhance the Commission's ability to protect our nation's securities markets”. The full implications of the regulation are not yet clear, but we will track them.

V. LHA Analysis and Practical Impact

Clearly, hedge funds have become a significant force in the investment world and play a meaningful role for micro- and small-cap public companies. More than ever it is necessary to market to them and weigh their concerns as shareholders, often very vocal shareholders, not just because of a fiduciary duty to do so but because it is good investor relations practice. We recommend:

- Identification: Not all hedge funds are big shorts looking to drive a stock down by any means, fair or unfair. The key is to identify which are worth cultivating and which require more careful handling. LHA’s ongoing market intelligence function and our constant contact with the Street position us well to help our clients identify incoming inquiries.
- Proactive Outreach: As part of our sophisticated marketing intelligence function, LHA continues to make new relationships with appropriate quality investors, including new hedge fund managers, to determine suitable investment targets for our clients.
- Preparation and Communications Style: Many hedge fund managers are extraordinarily aggressive by nature, a quality that can be very off-putting for public company management teams. However, aggressive does not always mean antagonistic, though many micro- and small-cap management teams will likely have a very tough conversation with a hedge fund manager at some point in their public company tenure. We will continue to help clients prepare for contact with this type of investor in order to help remain composed and stay on message.

We encourage our clients to leverage us as a resource in qualifying incoming inquiries, handling hedge investors, and incorporating hedge fund outreach into an effective investor relations program.