THE LONG VIEW

ADAM EPSTEIN
Small cap hedge funds should double down on corporate governance

"MANAGERS THAT INVEST TRILLIONS OF DOLLARS KNOW THAT BETTER GOVERNED COMPANIES MAKE MORE MONEY"

Iconic global asset managers such as BlackRock, Vanguard and Fidelity have scores of people focused upon analysing the corporate governance of their portfolios' companies. Similarly, pension funds like Calpers and Calstrs have become increasingly vocal about corporate governance best practices.

These firms are all spending more time and more money on assessing the corporate governance of their portfolio companies for one principal reason: they know that better governed companies create more shareholder value.

The best example of the nexus between corporate governance and shareholder returns is activist funds, whose limited partners have benefited dramatically from hundreds of assaults on boardroom inadequacies.

But if all you do is read the *Wall Street Journal* or watch CNBC and Bloomberg, you could easily be cajoled into thinking that corporate governance only matters at large public companies. Interestingly though, according to Activist Insights, 73% of all shareholder activist campaigns in 2015 were directed at small-cap companies (and smaller) – where corporate governance shortcomings are common and particularly penal to shareholders.

In light of the foregoing, you would think that the special situation hedge funds (SSHFs) that injected $28bn into the small-cap financing ecosystem in 2015. according to Sagient Research, would be laser focused on corporate governance. You would, however, be mistaken.

SSHFs extensively analyse competitive landscapes, distribution channels, supply chains, technology, science, capitalisation and corporate disclosures prior to investing directly into small-cap companies. But pre-investment corporate governance assessments and post-investment board monitoring are virtually never undertaken.

It's a poignant disconnect. Asset managers that invest trillions of dollars know that better governed companies make more money. Shareholder activists are steadfast that systemically substandard governance of small-cap companies costs shareholders dearly. Yet SSHFs that provide billions of dollars of growth capital annually to small-cap companies spend virtually no time or effort assessing or monitoring corporate governance.

Here are three reasons why they should.

Illiquidity: Unlike other hedge funds, SSHFs often make investments that are challenging to liquidate. More specifically, many small-cap stocks don't trade sufficient volumes to allow institutional investors to readily exit their positions (i.e. the funds were only able to acquire their positions by investing directly into the companies). Moreover, SSHFs regularly purchase restricted stock that isn't registered for resale by the SEC until the filing and effectiveness of a registration statement. SSHFs need to largely rely upon pre-financing diligence and deal structure to mitigate risk, since they might not be able to exit at optimal times and prices. Consequently, assessing the qualifications and objectivity of the board prior to investing has a heightened importance – illiquidity and porous oversight is a bad combination for institutional investors.

Because they can. SSHFs principally invest directly in small-cap companies through financings. While illiquidity can certainly be a disadvantage to direct investing, SSHFs often enjoy advantages that open market purchasers don't. For example, depending on the type of financing, SSHFs often have material access to insiders in advance of making investments. In addition, SSHFs not only have the access, but they also often enjoy a certain degree of negotiating leverage during the financing process.

Because they'd likely make more money. Misallocation of capital and poor execution by portfolio companies are repetitive, lethal shortcomings in the small-cap world. But what many managers don't always appreciate is that objective, fulsome oversight undertaken by qualified directors can obviate capital allocation blunders and limit the damage caused by management underperformance. These aren't management problems as much as they are often avoidable boardroom failures.

Higher sustained performance for SSHFs could well lie in bridging the boardroom divide; how could SSHFs care so little about corporate governance when those who manage trillions of dollars think the exact opposite?

Managers who continue to believe that corporate governance is simply tantamount to lawyers blathering on about fiduciary duties and Delaware law are leaving a lot of their limited partners' money on the table. ■

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THE SHORT VIEW

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The Base Erosion and Profit Shifting (Beps) package is gradually being implemented across all G20 nations. This is particularly true of European Union (EU) nations, with the UK reaffirming its commitment to the regime in its 2016 Budget this month.

Beps essentially seeks to address tax planning strategies exploiting imperfect tax rules to artificially shift profits to low or no-tax jurisdictions with little or no economic activity. But since the inception of the initiative, it has posed a number of difficult questions for a hedge fund industry worried it will become the unintended target of a regime looking to clampdown on tactics used by large multi-national companies

One big question is how best can a fund demonstrate its jurisdiction of "permanent establishment"? Where do hedge funds stand on double tax treaties? Will Beps prevent the industry in the EU developing, in line with the proposed Capital Markets Union, to provide alternative sources of lending to SMEs?

At the recent Jersey Finance conference in London, these questions led to some frank and lively criticism directed at key figures involved in driving forward the new regime, namely Pascal Saint-Amans, director of the Centre for Tax Policy and Administration at the Organisation for Economic Co-operation and Development (OECD).

Following the lively debate, *HFMWeek* spoke with Saint-Amans to find out how the OECD was looking to address the concerns of the hedge fund industry. Saint-Amans says he recognises industry concerns but believes many of these already exist and have not been created by the Beps regime. He has, however, committed the OECD to more consultation with the hedge fund space as Beps is rolled-out globally.

His comments have been welcomed by Aima, which this week reaffirmed its commitment to working with the OECD. ■

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