Sentinel

Personal Financial Management Ideas

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The Growing Benefits Of Private Ownership

By Jonathan M. Bergman, CFP

Regulators and impatient investors are driving U.S. public companies to go private. Major investors, along with some executives, will gain; other investors can only watch.

While public company officers and directors spend more time these days on administration and less time growing their businesses, the private equity world asks only one thing from its executives: Grow earnings and cash flow meaningfully over the next three to five years. Which type of company would you rather own?

Wall Street's heavy hitters are voting with their dollars, and the private companies are winning in a landslide. While fewer companies are going public than in the last strong market of the late 1990s, far more are going private, in deals that are far bigger.

But not every investor gets to cast a ballot. U.S. securities rules typically limit investments in unregistered securities such as hedge funds and private equity funds to individuals with at least $5 million in investments and institutions with $25 million. "Funds of funds" can have smaller minimums, but even those generally require at least $1 million in net worth or $200,000 in annual income.

Public company executives face daunting pressure to at least meet, if not top, the stock market's earnings expectations for each and every quarter, while avoiding any risky bets that could trigger litigation — justified or not — if the stock price abruptly tanks. Such litigation could even jeopardize the personal assets of the public corporation's top officers and directors.

Enron and WorldCom were colossal failures that arose from fraud and deceit. Nonetheless, even though *management* committed fraud, the *outside directors'* personal assets were at stake. They wrote checks totaling $31 million from their personal accounts to settle shareholder lawsuits.

The U.S. Justice Department and Eliot Spitzer, former New York attorney general and current governor, also have attacked the personal assets of executives and directors. These law enforcers went so far as to threaten companies with indictment if the companies paid the legal fees of officers, directors and employees under investigation for alleged criminal actions during their employment. Other demands from these justice crusaders have included requirements that corporations and their employees waive attorney-client privilege. These coercive tactics will drive more companies to take less risk. As three law school professors pointed out in the Winter 2005 edition of the journal *Stanford Lawyer*, "With jittery directors at the helm, prudent caution can readily transform into counterproductively defensive decision making and even paralysis in the boardroom."

In this unfriendly environment, directors may quit for fear of losing personal assets, may insist on more conservative business plans or may let attorneys run the board. As one private equity executive noted, "Boards of publicly traded companies are now focused on process, not substance."

Private equity returns have outpaced public market returns over the last couple of decades. If current trends continue,

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Canada Settles Issues While America Belabors Them

By Larry M. Elkin, CPA, CFP

SHERBROOKE, Quebec — As night falls and a frigid December wind blasts across Quebec's Eastern Townships, the 100-foot-tall illuminated cross atop Mont Bellevue commandeers this small city's skyline.

The sight of it startles me. Just an hour earlier, I was standing at the mountain's base, watching snow guns furiously try to compensate for nature's lethargy in time for an approaching weekend. Mont Bellevue is a city park, 900 vertical feet laced with ski trails that offer a convenient workout for *Sherbrookois* when they are disinclined to travel to taller peaks. From the simple base lodge, with no view of the summit, I had no idea that the cross existed.

But that is not why the sight surprises me. I find the cross startling because Americans do not place religious symbols in city parks. Occasionally someone tries, and we end up in court reaffirming that our form of religious freedom — separation of church and state — requires that emblems of faith stay off public property.

Sherbrooke's civic leaders intended to create an emblem of faith when they erected the cross in 1950. Other towns in this historically French Catholic province, including Montreal, have similar crosses. As in Montreal, the cross in Sherbrooke has gradually become more a civic symbol than a religious artifact.

Audrée Tessier photo

A chairlift carries summer visitors past the cross atop Mont Bellevue in Sherbrooke, Quebec.

I visited Sherbrooke the day after Canada's House of Commons voted 175-123 against repealing the 2005 law that legalized same-sex marriage nationwide. Prime Minister Stephen Harper, whose Conservatives had pledged to try to restore traditional limits to marriage, declared after the vote that the issue was now settled. Not only did his minority government lack the votes to roll back the law, but several of his own ministers voted against repeal.

I see a sharp contrast between these neighboring societies. Americans endorse church-state separation, but a strong religious subtext runs through one political controversy after another: same-sex marriage, school prayer and perhaps most of all, abortion. One side talks about family values, the sanctity of life, protecting marriage and putting God back in the classroom. The other side talks about freedom of choice, the right to privacy and religious liberty.

Canada, on the other hand, puts crosses on municipal mountaintops, but seems to have no place for religious agendas on more substantive secular matters. In the three years since Canada's courts first ruled on the issue, this country has formed a national consensus behind same-sex marriage. It has been 13 years since the Hawaii Supreme Court first ruled in favor of gay marriage. In that time, one state — not Hawaii, which changed its state constitution in response to the court ruling, but Massachusetts — has adopted same-sex marriage, three have instituted civil unions, and a handful are considering similar arrangements. But most states, as well as the federal government, adamantly refuse to recognize same-sex unions and have adopted statutes or constitutional amendments to block them.

Canada has been much faster than the United States to settle its abortion and school prayer issues, as well. The country has had, since 1988, essentially no restrictions on abortion. No significant legislation has been proposed on

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INVESTMENT FOCUS

A Fundamentally Better Stock Index?

By Paul Jacobs, CFP

Investors should avoid the new "fundamentally weighted" equity indices launched recently in an effort to outperform widely used indices such as the S&P 500 Index. Until some design flaws are addressed, there are much better alternatives.

The latest debate in the world of indexing is market capitalization weighting vs. fundamental weighting. Market capitalization is determined by multiplying the number of shares outstanding by price per share. The result is the value that the market places on the company. The typical index, such as the S&P 500, uses market cap weighting. The index allocates a weighting to each stock based on its market cap relative to the entire population of stocks. If a stock's market cap is 1 percent of the population, then the index will allocate 1 percent of its weight to that stock. The underlying assumption is that the market, in its collective wisdom, values companies correctly.

> The … assumption is that the market, in its collective wisdom, values companies correctly. After a three-year bear market from 2000 through 2002 that saw the S&P 500 drop 49 percent, investors began asking if there was a better way.

After a three-year bear market from 2000 through 2002 that saw the S&P 500 drop 49 percent, investors began asking if there was a better way. Looking back to 2000, the S&P 500 was over-weighted in technology stocks that the market had seriously overvalued. Enter the fundamentally weighted index.

The argument for fundamentally weighted indices goes like this: Instead of allocating weightings based on market cap, weightings should be determined by some objective measure of "fundamental" value. After all, market cap is highly subjective. It is determined by ordinary people, and sometimes we make mistakes. The technology bubble of the late 1990s serves as an example.

A major proponent of indexing, professor Jeremy Siegel of the Wharton School of the University of Pennsylvania who wrote "Stocks for the Long Run," has recently come out in favor of fundamental indexing. WisdomTree Investments Inc., for which Mr. Siegel serves as a senior advisor, recently launched several fundamental index funds that weight stocks based on dividend yield. This way, the company that pays out the most in dividends receives the highest weighting. Siegel argues that dividends are an objective measure of a company's size and value. After all, the cash used to pay dividends has to come from somewhere, and it can't be generated by accounting shenanigans. According to back testing (applying the new indices' strategy to prior time periods), the company's domestic large-cap, mid-cap and small-cap indices all outperform indices from Standard and Poor's and Russell.

So the lines have been drawn. Supporters of the efficient market hypothesis say that market cap weighting is the superior method, since they believe that all stocks are priced appropriately. Fundamental weighting draws its followers from those who are looking for a better way to index. They want to weight stocks based on something more objective than the collective wisdom of the market. A third camp is made up of those who still believe that active portfolio management will beat indexing over the long term, but we'll leave those lost souls for another article.

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So who's right? Well, first of all, let's point out the obvious: Over a short period, there's no way to tell which strategy will outperform. However, over the long term we can determine what kind of returns and volatility to expect from these indexing strategies. For example, using historical data for the S&P 500, we can make an educated guess about the index's future. The S&P 500 is highly diversified, and it has returned, on average, over 10 percent a year since 1926. There have been ups and downs along the way, but the volatility we saw recently during the three-year bear market was atypical.

Fundamentally weighted indices, because of the way they are constructed, can end up looking like very different animals. For example, by weighting stocks based on dividend yields, the WisdomTree indices concentrate on certain industries. The indices are also much more sensitive to interest rate movements than market cap weighted indices.

First, an example of the focus on high-yielding industries: the WisdomTree Smallcap Dividend Index is almost 60 percent invested in the financial sector. This is not a typo. For comparison, the S&P Smallcap 600 Index allocates only 16 percent to the financial sector. Companies in the financial industry typically offer high yields, which skews the WisdomTree index toward these companies.

Next, an example of interest rate sensitivity. The WisdomTree Web site proudly trumpets how its indices have outperformed more well-known indices since 1980. However, any follower of the market knows that interest rates have headed in only one direction since 1980: straight down. Since decreases in interest rates make higher-yielding stocks more attractive, of course these indices have outperformed! To illustrate, for the five-year period beginning Sept. 30, 1981, the yield on the 10 Year U.S. Treasury Bill fell from its peak by 53 percent. Figure 1, above right, indicates relevant returns for this period. Instead of a WisdomTree Index, it substitutes the Fidelity Equity Income Fund, which focuses on high-yielding stocks and began operations in 1966.

The first lesson from this table is that strategies focusing on yield will tend to outperform during periods of falling interest rates. Another lesson is that a focus on yield is not the same as a value focus. Value investors typically look for mispriced stocks selling at low multiples of profits, assets or some other metric. High yields and low multiples do not always go hand in hand. Therefore, when evaluating an index that is weighted based on dividends or other fundamental measures, it may not be appropriate to assume it will perform similarly to a broad value index.

Figure 1

Investment	Annualized Return from 9/30/81– 9/30/86
Fidelity Equity Income Fund	24.29%
Russell 1000 Value Index	22.29%
S&P 500 Index	20.17%

Issues With Fundamental Weighting

The allure of indexing for the average investor is that it provides low-cost exposure to the entire market. Market cap weighting accomplishes this goal. Every public company has a market cap, so it will be given some weighting, however small. But fundamental weighting can lead to companies being excluded. For example, by weighting stocks based on dividends, any company that does not pay a dividend will not be included in the index. Those fast-growers with 0 percent dividend yields? Forget them. The only way to gain exposure to these companies using WisdomTree's funds would be to wait until the company initiates a dividend (think Microsoft).

Many stock-picking models have been created that have excellent back-tested returns. However, these models rarely, if ever, are successful going forward. While fundamental weighting with dividends may have worked in the past, there is no guarantee it will work in the future. In addition, we don't know what further back testing of the model would have shown. Perhaps returns would have dropped significantly.

After reviewing the data, it's clear that fundamental weighting isn't without its flaws. But market cap weighting isn't perfect, either. A dividend-weighted index will outperform periodically, and it may have a place in a yield-hungry investor's portfolio. However, market cap weighting provides greater diversification, which leads to reduced risk. Since investors vote with their dollars, the battle is still being won by the market cap indexers. We'll see if the fundamentally weighted indexers can design better indices and end up winning the war.

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private equity returns will likely increase their lead. According to Thomson Financial/National Venture Capital Association, through June 30, 2006, the annualized 10- and 20-year returns, net of fees, for all private equity funds were 11.4 percent and 14.2 percent, respectively, compared with 8.3 percent and 11.0 percent, annually, for the S&P 500.

Cash flow growth drives investment returns, and private companies — at least the ones run by the industry's top players — seem to be doing better at building their cash flows. In its marketing material, one major private equity firm states that its portfolio companies increased their cash flow by 14 percent annually, on average, from 2000 through 2005. The broad-based Russell 3000 index, on the other hand, saw its cash flow growth increase by 7 percent annually over the same period.

In a private company, risk is *managed*, not *avoided*. Many private companies take on significantly more debt than public companies, frequently securing twice as much debt as equity. Compare that with non-financial companies in the S&P 500, which, according to *Barron's*, had about twice as much equity as debt in 2006. As long as interest rates remain near 25-year lows, greater leverage should not pose a problem for private companies. But higher interest rates would put pressure on companies that overborrowed. Some could fail.

Nonetheless, private equity firms encourage their management teams to take risks. There is no fear of shareholder lawsuits, other than for outright fraud, and the Securities and Exchange Commission has no jurisdiction over private companies. Diversification plays a large part in private equity shops' risk-management strategies. Most private equity funds invest in 10 to 20 portfolio companies. While nobody likes to see any business fail, private equity firms accept that a few of their portfolio companies will not succeed. In a private equity fund, if 12 companies are successful and three fail, the fund will still likely generate an excellent investment return for its clients. Therefore, all of the fund's companies may take appropriate risk as a result of a fund's diversified portfolio.

In contrast, every public company must manage its risk as a stand-alone entity for which failure is catastrophic. Nearly every failure of a significant public company generates shareholder lawsuits, among other unpleasantness. Public companies therefore are inherently more risk-averse than firms held within private equity funds. Because risk and return go hand in hand, private company investors can expect to do better.

Beware Of Management Buyouts

Management-led buyouts, an increasingly popular component of the private equity boom, have investors wondering if the fox is guarding the henhouse.

In a typical arrangement, a company's existing management joins forces with a financial sponsor to buy the outstanding stock of all public shareholders and take a company private. Due to the conflict of interest between the buyer (management) seeking to buy low and the seller (the board, which may include members of management) seeking to sell high, the board often establishes a special committee of independent directors to analyze the proposed deal. An investment bank is hired to express its opinion on the deal's fairness.

Of the more than 600 management-led buyouts globally in 2006, one in particular attracted attention. Shareholders of Four Seasons, the luxury hotel chain, were offered a 28 percent premium to their stock's previous closing price by management and its financial partners. Management is required to act in the best interest of all shareholders. Still, that did not prevent Isadore Sharp, chairman and chief executive officer of Four Seasons from boldly

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One sign of how public companies have become more risk-averse in the post-Enron era is in their cash holdings. Non-financial S&P 500 companies now hold nearly 10 percent of their assets in cash, compared with 5 percent 10 years ago. The cash provides an extra cushion against business setbacks. But retaining high cash levels lowers a company's return on equity, reducing an investor's expected rate of return.

Public Executives Face More Demands

A Palisades Hudson client who is CFO of a publicly traded company estimates that he spends 30 percent to 40 percent of his time communicating with investors. Executives at private companies focus on improving their businesses. Therefore, it is no surprise that senior executives are beginning to prefer running private companies. (**See accompanying story.**)

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In a striking example of this trend, David L. Calhoun, vice chairman of General Electric and head of its most profitable unit, Infrastructure, left in August to become chairman and CEO of VNU Group, a media company that was recently taken private by a consortium of investors. Calhoun was a candidate for several top public company posts and was named by *Fortune* in 2006 as the most sought-after executive for a CEO position.

Calhoun may have joined VNU for more money (reports have suggested up to $100 million if VNU executes its long-term plan); he may have joined seeking a new management challenge; or he may have joined so that he could be free to do his job the way he thinks is best. Addressing a group of private investors in November, Calhoun said it is nearly impossible to restructure a public company because investors are too concerned with companies meeting quarterly earnings estimates rather than making strategic decisions that affect long-term results.

Amid the recent criticism of executive pay packages, could Calhoun have reached an agreement that might lead to a $100 million payout at a public company? My guess is no.

The private equity firms that own VNU are willing to pay Calhoun a bundle, but only if he succeeds. According to media reports, and consistent with industry practice, Calhoun will make an adequate salary, but he won't be paid handsomely until VNU's investors are paid handsomely. This is a major improvement from some public companies, which bestow sizeable salaries on their executives regardless of whether the company meets its financial targets. Again, consistent with industry standards, Calhoun also will be required to invest a substantial portion of his net worth in VNU. Calhoun will have his big payday when the private investors have their big payday — and not before.

SOX Needs Mending

The Sarbanes-Oxley Act of 2002, or SOX, enacted after the accounting scandals at Enron and WorldCom, has created additional concerns for public companies and their managers. The law requires each public company's chief executive and chief financial officer to attest to the accuracy of the company's financial reports. A false certification can bring up to 10 years in prison and a $1 million fine if it is "knowing" and up to 20 years and $5 million if it is "willful." While CFOs arguably should have been deeply involved in corporate accounting issues all along, there is no doubt that SOX requires CEOs to devote much more attention to financial reporting, leaving less time for other matters that might have more to do with a company's long-term success.

SOX also demands a greater role for independent directors on corporate boards, and it imposes more rules governing internal reporting systems. Though those rules are not unduly expensive for large enterprises, several smaller public companies have gone private rather than incur substantial costs to implement SOX controls. According to accounting firm Grant Thornton, the number of public companies of all sizes going private jumped 30 percent in the 16 months following the passage of SOX compared with the 16 preceding months. As more public companies go private, public equity investors who do not qualify to own unregistered securities, or for whom relatively large and illiquid private investments are inappropriate, will be left with fewer options.

Some help may be on the way. The Committee on Capital Markets Regulation, a group of business leaders and academics chaired by Glenn Hubbard, former White House economic advisor, and John Thornton, former president of Goldman Sachs, concluded in a November report that "The United States is losing its leading competitive position...[O]ne important factor contributing to this trend is the growth of U.S. regulatory compliance costs and liability risks compared to other developed and respected market centers."

Among the committee's recommendations were changing portions of SOX to limit auditor liability and to provide some regulatory relief for smaller public companies, and limiting certain litigation against auditors, directors and management.

These recommendations are a step in the right direction. Public company executives are fed up with SOX compliance, compensation questions and investors' constant demand for short-term results. They, and their companies, will transition ever more into private ownership. The private equity firms, which face little threat of being sued by investors or regulators, will take on more risk and will make more money. These gains will flow to those private equity firms and their clients, namely wealthy families and institutions. Individual investors who cannot or do not invest in private companies will have fewer investment opportunities and lower returns.

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the subject since 1989. This is true even though Canada flatly prohibited abortions until 1969 and made them available on a much more limited basis from then until 1988 than did the United States following the 1973 *Roe v. Wade* decision.

The U.S. Supreme Court struck down prayer in public schools in 1962. We are still arguing about it. Several Canadian provinces opened the school day with Bible readings and the Lord's Prayer as recently as 1988, when an Ontario court outlawed the practice. School prayer is not a significant issue in Canada today.

Why do Canadians get past these issues so much faster than Americans? Political scientists might note that Canada's Charter of Rights and Freedoms was adopted in 1982, so its view of personal liberties reflects our era's experiences and a recent national debate. The American Bill of Rights was part of the Constitution adopted in 1789. Many of our disputes center on how to reconcile the words written more than two centuries ago, and the ideas of the white, landholding men who wrote them, with the issues we confront today.

A more cynical view might be that the Democratic and Republican parties are more interested in politically advantageous "wedge issues" than solutions. Republicans who allied themselves with religious conservatives decades ago have made effective use of social issues to motivate their voting base. Democrats have their own wedge issues, of course. Minimum-wage initiatives were a popular Democratic device in the recent election. Social Security is a Democratic evergreen. The perceived evils of oil companies, health insurers and drug makers are on the list.

Four significant parties exist at the federal level in Canada. If the purpose of a wedge issue is to create a "them vs. us" dynamic, a wedge might be less effective in such a fragmented system. Of course, Canadians have divisive political issues, too. It's just that with the exception of the eternal tensions between English and French Canada, I am more likely to figure out the scoring system at a cricket match than to understand what Canadians are arguing about. Or even to recognize that they are arguing, since Canadians are so unfailingly nice.

The worst thing about wedge issues is that the party using them has no incentive to solve the disputes, as long as the disputes themselves help to win elections. With Democrats holding such a slim majority in Congress, and with that majority and the White House at stake two years from now, I expect the new Congress to accomplish very little. But I expect it to work diligently to forge new and potent wedges for the 2008 campaigns.

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stating in the press release about his buyout offer, "Having given this proposal very careful consideration, this transaction, with these investors, is the only one I am prepared to pursue."

It's not hard to see why several commentators have suggested that management-led buyouts are great — for management. Ben Stein, a free-marketer and frequent contributor to *The New York Times* Sunday Business section, went so far as to suggest that "... these deals should be illegal on their face." Stein continues, "... as a matter of basic fiduciary duty law, managers are bound to put the interests of stockholders ahead of their own, in each and every situation. By buying the assets on the cheap and then reaping the benefits, management is breaching that fiduciary duty…"

One may wonder how management is "buying the assets on the cheap." Stock traders in the public markets determine a stock's value based on everything that is publicly known about a company. Therein lies the rub. A public corporation's managers, who are supposed to work in the interest of the public shareholders, have access to material, nonpublic information. It is illegal to trade stocks on the public market based on such information, but this rule has not been applied to management-led buyout offers.

When those trusted to manage an enterprise on behalf of absentee owners suddenly want to buy the entire company, be suspicious. It's rare that a fiduciary buying from its client acts in the client's best interest.

— Jonathan M. Bergman

Duly Noted

Feds To States: Hands Off Nonresident Partner Income. States cannot use "source tax" rules to tax retirement income paid to nonresident or former resident partners, under legislation recently signed by President Bush. The legislation extends to partners a 10-year-old ban on state taxation of retirement benefits paid to employees. To qualify, the benefits must either come from a tax-qualified retirement plan or from a non-qualified plan via substantially equal periodic payments over a period of at least 10 years. The legislation also provides that benefit caps and cost of living adjustments do not prevent payments from satisfying the "substantially equal" requirement. Only the recipient's current resident state can tax retirement payments under the federal rules. However, some states popular with retirees, including Florida, Nevada and Texas, have no personal income tax. *H.R. 4019*, 2006 TNT 143-7.

Medical Reimbursements Taxable For Same-Sex Partners. Employer-provided medical expense reimbursements for an employee's same-sex partner are taxable unless the partner qualifies as the employee's dependent, under a recent Internal Revenue Service ruling. Moreover, if a reimbursement plan covers anyone other than the employee, a spouse or a dependent, reimbursements of the employee's own expenses and expenses of a spouse or dependent also are taxable, according to the Service. The federal government does not recognize same-sex marriages, which now are legal in Massachusetts and several foreign countries, or civil unions, which are available in Vermont, Connecticut and New Jersey. To qualify as a dependent, a domestic partner cannot have gross income exceeding $3,300 in 2006. *Rev. Rul. 2006-36,* 2006 TNT 157-3.

Tax Examiner Fired For Nonpayment Of Taxes. The IRS was within its rights to fire a tax examiner who failed to pay her 2002 income taxes, a federal appeals court ruled. Heather Bennett had previously drawn a 15-day suspension for failing to pay taxes for 2000 and 2001. The IRS fired her in 2005 after a routine computer screening identified the 2002 nonpayment. The employee blamed the problem on a dispute with her mortgage company. She claimed her dismissal was unduly harsh and that the two disciplinary actions should have been combined to avoid the more severe penalty for a second violation. But the U.S. Court of Appeals for the Federal Circuit held that "Ms. Bennett held a frontline position in ensuring taxpayer compliance" and that the IRS justifiably found that "her offense struck at the core of the agency's mission." *Bennett v. Department of the Treasury,* No. 06-3229.

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