Notes and highlights for

the problem of twelve_john coates

John Coates

Chapter One: What Came Before: The Twentieth Century's Public Company

Highlight (yellow) - Location 174

This chapter reviews how the US economy came to be dominated in the twentieth century by what is called "the public company." Public companies are large businesses with shares traded on a stock exchange. Examples are household names: Apple, AT& T, Costco, Exxon, IBM. Roughly 70 to 80 percent of all corporate ownership has for over a hundred years consisted of public companies' shares.

Highlight (yellow) - Location 177

There is a deep, structural conflict between American-style democratic republicanism, on the one hand, and capitalist economics, particularly in finance, on the other. Democracy as practiced in the US has from the founding been suspicious of, and has imposed legal and political control over, any kind of concentrated power. Capitalist markets often generate economies of scale in finance, which tends to concentrate wealth and power. The result is a repeated pattern of evolution toward concentration, followed by political reaction and the embrace of laws and institutions that effectively sacrifice some economic value to thwart the risk of tyranny.

Highlight (yellow) - Location 190

But in the largest public companies, shareholders have long been so numerous— no one person owns more than 1 percent of a company's shares— that contested elections of directors are rare. Because board members are typically independent and serve part-time, they have limited ability to direct managers. While boards grew in power at the end of the twentieth century, they still impose only mild constraints on executives. As a result, large public companies for most of the twentieth century were controlled not by their owners but by their executives.

Highlight (yellow) - Location 196

For most of the last century, power in public companies— and so in the overall economy— was achieved through a professional career in management: typically, an MBA from a business school, an entry-level management job, and steady progress within a corporate hierarchy. Overall, managerial success blended meritocracy, occasional nepotism, and organizational politics. In sum, the US economy became "managerialist,"

Highlight (yellow) - Location 200
Managerialism was an accidental by-product of two forces, one economic, one legal and political: first, the economies of scale produced by the revolutions in production, transportation, and communication of the nineteenth century, and second, laws inhibiting large banks from emerging in the US, and which barred equally large insurance companies (which did emerge) from owning public companies' stock.

Highlight (yellow) - Location 203

The problem of twelve, then, is largely about the threat in the present moment posed by index funds and private equity funds to a class of American corporate managers, and to the economy they have dominated for a hundred years. To set the stage for how the problem of twelve emerged, this chapter briefly reviews how and why managerialism emerged, how it was controlled, and how it achieved enough legitimacy to endure for a century.

Highlight (yellow) - Location 218

In effect, large public companies were becoming stronger than government. Their dominance made it important to identify who controlled them, and how they were controlled. Berle and Means were the first systematically to argue that public companies were supervised not by their owners, as property had been in the past, but by professional managers, who tended to own little stock in the companies. This theme of the "separation of ownership and control" is the enduring contribution of Berle and Means to understanding how large businesses function.

Highlight (yellow) - Location 243

In large part, the legitimacy that public companies eventually achieved owes much to Franklin Roosevelt's embrace of a regime of "full and fair disclosure" in 1933, and in 1934 the creation of the Securities and Exchange Commission (SEC) to instantiate that regime. The SEC enacted and enforced rules for public companies, requiring them to publish annual reports, to pay for independent audits, and to embrace better governance in the form of rules for how dispersed shareholders could vote, and with what information. These changes were real, salient, and publicized.

Highlight (yellow) - Location 255

The SEC's start-up period met massive resistance in specific areas— particularly from the stock exchanges, whose power in the capital markets had only increased in the twenties, and from public utilities, which had the worst features of Berle-Means size, ownership dispersion, economic concentration, and insulation from accountability. Yet after a fraught transitional decade, the constraints of SEC rules came to be accepted by most business leaders, however grudgingly, as remedies for the global economic ills of the Depression that were far milder than the alternatives of fascism or socialism.

Highlight (yellow) - Location 259

It is sometimes forgotten that American socialism— so often emphasized as a dire threat to freedom during the Cold War— remained a live option in the US through World War II.

Highlight (yellow) - Location 268

By forcing companies to be open about risks and to account for their activities, and by helping create safe securities trading markets, SEC rules led investors to be willing to provide companies with capital at a lower price than in other developed economies. Capital markets deepened, and became more liquid, as a result of SEC oversight, further reducing the cost of capital. Cheaper and more liquid capital, in turn, helped companies to grow, to generate jobs, and to distribute wealth among a large class of workers and investors. US capital markets remain the largest and deepest in the world, in large part due to the SEC.

Highlight (yellow) - Location 272

From the 1930s to the 1980s, a typical Berle-Means-style US public company went through a fairly standard life cycle, consisting of three phases of capital raising and governance.

Highlight (yellow) - Location 273

In the first stage, entrepreneurs created companies with capital from some mix of savings, speculative investment from "family, friends, and fools," and, for many companies from the 1950s on, from venture capital firms.

Highlight (yellow) - Location 278

In the second stage, after getting a business to the stage where it was generating revenue and appeared sustainable, an entrepreneur would take the firm public in an initial public offering— that is, sell shares to dispersed, anonymous investors, and list the stock on a stock exchange.

Highlight (yellow) - Location 284

In the third stage— with ownership separated from control, and dispersed investors rationally ignorant and passive— any external harms public companies might inflict on anyone other than their shareholders were kept in check by the large body of law and regulation created by the New Deal and the labor unions they empowered. No one manager or group of managers controlled more than one large public company, and antitrust law largely prevented the domination of any industry by any one company.

Chapter Two: The Rise of Index Funds and the Problem of Twelve

Highlight (yellow) - Location 293

The American corporate governance system sketched out in chapter one is dying. Two new types of institutions— index funds and private equity funds— have increasingly and persistently begun to disrupt the public company model. Index funds are investment vehicles for both ordinary people and big institutions: you give them your money, and they try to replicate the overall performance of the stock markets, while charging you only minimal fees. Private equity funds, whose investors are mostly institutions, buy a controlling ownership in companies, often taking them off of the public markets, and then resell them a few years later. These have been by far the fastest growing types of ownership of companies over the last generation.

Highlight (yellow) - Location 300

Index funds have now gathered so much capital and concentrated so much ownership that they have enough voting power to strongly influence, if not determine, how public companies are governed. Corporate managerialism is threatening to give way to index fund managerialism. No longer do we have an economy controlled by thousands of executive managers of thousands of public companies, held in check by an array of dispersed governance institutions. Instead, we increasingly have an economy overseen by a concentrated collection of roughly a dozen index fund managers, who collectively have enough corporate power to determine the fate of most public companies.

Highlight (yellow) - Location 323

Larry Fink, the CEO of the largest index fund company, BlackRock, which controls $ 10 trillion in assets, had made repeated public comments indicating that his firm would be expecting the companies in which it invested to do more to take account of the long-run risks of their activities, especially from climate change.

Highlight (yellow) - Location 330

During the 1960s and early 1970s, in publications by MIT management professor Paul Cootner, Princeton economist Burton G. Malkiel, Chicago economist Eugene Fama, and MIT economist Paul Samuelson, academic researchers advanced several bold ideas— still counterintuitive to many: Stock prices reflect all available information— the “efficient market hypothesis.” As a result, stock prices follow an unpredictable “random walk.” The best overall method for investing by ordinary individual investors would be to give their savings to funds that would not try to predict the market, but simply to buy and hold a preset basket of stocks.

Highlight (yellow) - Location 462

Another reason was that the costs associated with keeping track of thousands of fund investors and channeling their investments into hundreds or thousands of public companies declined from 1970 to 2000 due to new technology. The spreadsheet, email, the internet, and other forms of desktop computer technology made their way into the investment world in the 1980s and 1990s. Indexes became easier to produce and distribute.

Highlight (yellow) - Location 466

An additional cause of the migration of capital to index funds was globalization— a lowering of cross-border investment frictions due to the spread of information, along with legal changes reducing barriers to financial trade. Investors know more about their own countries and economies. This makes index fund investing comparatively attractive in a globalizing financial market.

Highlight (yellow) - Location 469

Most important, however, it simply takes a long time for basic but counterintuitive wisdom to penetrate the minds of most ordinary investors.

Highlight (yellow) - Location 484

More important than the sheer growth in indexing is the impact of indexing on concentration. As with capital investment generally, index funds enjoy economies of scale— more so than other types of funds. Indexing is by definition not a high value-added service, nor one on which different investment managers can hope to distinguish themselves. Indexing eschews efforts to beat the market. Index funds do not suffer as they grow, because it is not much harder to match the market at larger scales— all growth requires is to find more shares of stock to buy at current market prices. By contrast, portfolio managers who do attempt to beat the market find it increasingly more difficult as they deploy ever larger amounts of capital. Brand— built on reliability and low costs— is what matters for index funds, and the value of brand tends to grow, not shrink, with scale.

Highlight (yellow) - Location 498

In short, the rise of indexing has increased ownership concentration overall. When actively managed funds dominated the mutual fund market, their assets were spread among hundreds of advisors. Now that index funds have taken over the mutual fund market, the number of sizable index funds is tiny. The result is concentration of ownership in the hands of a very small number of index fund providers.

Highlight (yellow) - Location 501

The Big Three— Vanguard, State Street, and BlackRock— now control more than 20 percent of the votes of the S& P 500— a much greater share of US public companies than any three single investors have ever previously held. And their stakes continue to rise. In 2017, Vanguard owned 7 percent of IBM, and each of BlackRock and State Street owned 6 percent, adding up to 19 percent. By the end of 2018, the Big Three owned 21 percent. The same three fund complexes controlled more than 20 percent of ConocoPhillips.

Highlight (yellow) - Location 518

We are rapidly moving into a world in which the bulk of the equity capital of large companies will be owned by a small number of institutions, for the indefinite future. Those institutions, in turn, are controlled by a small number of individuals. For any given company, the ownership rights— most importantly, the right to vote in an election of directors— will be controlled by a small number of individuals working for those institutions. It is not an exaggeration to say that even if this mega-trend begins to taper off, the majority of the thousand largest US companies could be controlled by a dozen or fewer people over the next ten to twenty years.

Highlight (yellow) - Location 525

A key point is that index funds do not literally control every public company's operations in anything like a full sense. They are careful to not take actions that would lead anyone to claim successfully that they "control" any given public company in a legal sense; instead, they exploit the legal gap between "control" and "influence."

Highlight (yellow) - Location 528

As a result, even as they have generated massive economic benefits for their own investors, they have also stimulated criticism, from a governance perspective, along three lines— for having too much control, for using that control to harm consumers, and for being too deferential to managers.

Highlight (yellow) - Location 530

In a political sense, index funds may present the worst of two worlds— concentration and the risk of too much power, on the one hand, but actual passivity and too little governance activity on the other hand. When they use their power to push companies to do something different, they attract critiques based on the problem of twelve. When they decline to use their power, they attract critiques for failing their jobs as stewards of shareholder wealth.

Highlight (yellow) - Location 543

As with the dispersed individual investors on behalf of whom they invested, index funds had no rational incentive to engage in much governance activity. Any benefits would be shared with other owners of the portfolio company, but the costs would be borne by the fund and its investors.

Highlight (yellow) - Location 553

It enhances index funds' power that they regularly work with hedge funds, other kinds of institutional shareholders (particularly pension funds), and governance professionals to collectively pressure public company managers to act in various ways. In this division of labor, index funds have real and increasing influence. This influence takes several forms: policy influence, influencing and supporting governance activists, engagements, and, perhaps most importantly, contests for the overall control of a company.

Highlight (yellow) - Location 556

Index fund advisors formulate and publish policies regarding various kinds of decisions that the boards and managers of their portfolio companies must make. These policies are general, not specific to any one public company. Examples include whether a company should have staggered terms for board members, whether its CEO should be paid based on total shareholder return or on some other metric, and whether the company should disclose its political activities.

Highlight (yellow) - Location 562

No explicit collusion is required to send highly aligned signals about what they want to each other and to the management of portfolio companies. Rational managers anticipate goals and preferences of index fund providers, and then enact them, to some extent, without the need for explicit, public directives or exercises of power.

Highlight (yellow) - Location 577

For example, even before the ExxonMobil / Engine No. 1 proxy fight, it was BlackRock that pushed Exxon into disclosing the long-term portfolio impacts of global climate change policies. When BlackRock announced its support for a shareholder proposal calling for such disclosure, its announcement did more than just reflect BlackRock's intended vote. It triggered a wave of media coverage, and influenced other institutions and governance professionals to consider similar environmental disclosures more mainstream and acceptable than had previously been the case.

Highlight (yellow) - Location 619

The bottom line of this review of how index fund advisors use their power to control public companies is neither that they exercise pure control nor that they are passive, in the manner of investors in Berle and Means– style companies in the twentieth century. Rather than blindly choosing stocks in their index and then ignoring them, index fund managers have, and are increasingly using, multiple channels to influence public companies of all sizes and kinds. Their views on governance issues, their opinions of CEOs, their desires for change at particular companies, their response to and evaluations of proposals from hedge fund activists— all of these matter intensely to the way the core institutions in the US economy are operating.

Highlight (yellow) - Location 629

Pressure to increase shareholder returns can lead to layoffs. The mere threat of an activist supported by index funds can reduce investment. Reduced budgets for compliance increase the risk of bribery, mass torts, fraud, or antitrust violations. Index fund managers are in a position to increase or decrease the incidence and severity of externalities (e.g., climate change) and rent-seeking (e.g., political corruption). A small number of unelected agents, operating largely behind closed doors, are increasingly important to the lives of millions of people who barely know of their existence, much less their identity or inclinations.

Chapter Three: The Rise of Private Equity

Highlight (yellow) - Location 636

Private equity funds, such as Apollo, Blackstone, Carlyle, and KKR, are doing as much if not more than index funds to erode the legitimacy and accountability of American capitalism, not by controlling public companies, but by taking them over entirely, and removing them from the SEC's disclosure regime. Private equity funds are creating their own problem of twelve.

Highlight (yellow) - Location 644

Private equity is in part a long-term strategy of regulatory avoidance. Private equity funds are intentionally structured so as not to trigger disclosure laws. The private equity industry helped shape those laws, with lobbying and political influence. Once a private equity fund acquires control of a business, the business goes "dark." The results are less known to researchers and private equity professionals, much less to the public. General assessments of private equity are necessarily tentative. Yet we know enough about private equity to identify another problem of twelve in the making.

Highlight (yellow) - Location 656

Private equity funds are created by financial advisory firms. Those firms, along with their individual managers, typically invest 1 percent of their own money in a private equity fund's total capital. As shown in Figure 3.1, the rest of a private equity fund's capital is raised primarily from institutions, such as pension funds. Private equity funds use this capital to invest in operating businesses, just as index funds do.

Highlight (yellow) - Location 662

Index funds, however, buy stock in small amounts at a time, which in aggregate has grown enormously. Private equity funds usually buy all of the stock of a company, taking it over completely. In the seventies and eighties, these acquisitions were called buyouts. Funds borrowed money, a form of financial leverage, giving them greater buying power, so their deals were called "leveraged buyouts,"

Highlight (yellow) - Location 673

Private equity funds' relationships with their own investors also differ from index funds. While index funds provide daily liquidity by redeeming and selling shares, private equity funds collect capital commitments, and once invested in a business, do not allow their investors to exit for many years. Instead, each fund typically has a termination date— effectively a preset commitment to liquidate, seven to twelve years after formation.

Highlight (yellow) - Location 679

At first, private equity exits were initial public offerings. Over time, other exits became more common: sales to public companies; sales to other private equity funds (secondary buyouts); and most recently, sales to new funds managed by the same private equity firm (continuation buyouts).

Highlight (yellow) - Location 682

Private equity firms provide operational and strategic advice to companies they acquire, reshaping operations and even strategy. Because they use debt, they maintain relationships with banks, insurance companies, hedge funds, and other lenders (including other private equity funds). The debt they incur, plus their planned exits, lead private equity firms to try to increase a company's cash flow rapidly. They cut costs, often by laying off employees, cut capital investments, and try to expand profit margins and sales by refining product mixes and marketing strategies.

Highlight (yellow) - Location 686

A private equity firm typically operates at the hub of a wheel, with many private equity funds. Different funds are at the ends of the spokes, in different stages: some in formation, some on the hunt for deals, some exiting prior acquisitions, and some winding up.

Highlight (yellow) - Location 690

Today, more than a third of total corporate equity in the US is managed outside of public companies, with the fastest growth in businesses owned by private equity funds.

Highlight (yellow) - Location 693

Private equity firms now sponsor funds that focus not on traditional buyouts but on real estate and credit.

Highlight (yellow) - Location 705

Post-buyout companies no longer had to comply with SEC disclosure rules. Many saw this consequence of (and motivation for) buyouts as pernicious, by reducing the ability of the public generally to understand and trust capitalism.

Highlight (yellow) - Location 707

Going private raises questions about finance. Why would a concentrated fund pay more for a business than dispersed and diversified investors? Going private also involved conflicts of interest. A buyout fund will often ask current managers of a public company to invest in the buyout—putting the managers on both sides of the deal. Managers (and the fund) would earn more if the deal price were low. Yet as fiduciaries, managers were supposed to protect shareholders by demanding a deal price that was high. More fundamentally, why should managers profit from post-buyout improvements when pre-buyout shareholders would not? Many believed such buyouts could only make sense if managers were either deliberately underperforming pre-buyout, bringing the price down, or leaking inside information to attract a buyout. When prominent companies are acquired by managers at historically low prices, and taken public again not much later, at a much higher price, going private creates perceptions of abuse, both of information and position. These clouds hang over the industry to this day.

Highlight (yellow) - Location 721

Junk bonds were debt securities too risky to be investment grade. Those safer bonds were more predictable than stocks, and so were attractive to risk-averse, cautious, or liquidity-demanding investors. Historically, junk bonds were issued by "fallen angels"— companies that had stumbled, leaving debt in danger of default. Milken concluded they had attracted too much stigma, and were, when part of a diversified portfolio, cheap. Buying them would produce above-market returns, even adjusted for risk. Once retold by enough salesmen, this story allowed junk bonds to take off. Importantly, too, even the riskiest bonds at the time generated tax-deductible interest payments. With corporate tax rates high, this provided, in effect, a public taxpayer subsidy for the investment product, giving a lift to the rise in leveraged buyouts.

Highlight (yellow) - Location 731

Buyouts intertwined with two other features of the 1980s: hostile takeovers and insider trading.

Highlight (yellow) - Location 732

Stimulated by globalization and the challenging economy of the 1970s, buyout funds competed with and were given new roles by the corporate raiders of the 1980s. Swashbucklers like Texas oilman T. Boone Pickens denounced the managers of the entire oil and gas industry as incompetent sloths, and extracted greenmail with threats of hostile takeover bids. Buyers dramatically restructured their targets, forcing divestitures, downsizing, or liquidation. Layoffs and plant closures swept America: one in five blue-collar workers lost their jobs from 1981 through 1983. Prominent economists such as Larry Summers and Andrei Shleifer analyzed these takeovers of the 1980s as a "breach of trust" with workers and communities.

Highlight (yellow) - Location 739

leveraged buyouts overshot and succumbed to scandal.

Highlight (yellow) - Location 747

Some wondered if buyouts would recover. No high-profile buyouts occurred for years, although new funds did get created (Apollo in 1990 and Texas Pacific Group in 1992). Few anticipated that buyout firms would begin a dramatic expansion that would carry on for the next quarter century.

Highlight (yellow) - Location 755

What accounts for the rebirth and transformation of the industry from the mid-1990s? Any answer has to include politics, PR, lobbying, and deregulation.

Highlight (yellow) - Location 765

Reg D permits unlimited amounts of capital raising by any business from an unlimited number of moderately wealthy accredited investors.

Highlight (yellow) - Location 778

The biggest payoff from the political partnership between the venture capital and private equity lobbies (later joined by hedge funds) came in 1996, in a shift still underappreciated by many observers of the US capital markets.

Highlight (yellow) - Location 785

The act let funds raise unlimited capital from unlimited numbers of institutions or individuals with $ 5 million in investments. Previously, private funds were limited to a hundred investors. From 1996 on, private equity funds (and venture capital and hedge funds) could raise capital from hundreds or even thousands of institutions. With most of their capital now invested through institutions, private equity funds could stay dark without any regulatory limit on their scale.

Highlight (yellow) - Location 790

The result has been that private equity funds have scaled up dramatically. Not coincidentally, the 1996 act preceded a long drop-off in initial public offerings by US companies.

Highlight (yellow) - Location 799
In a concerted and ultimately successful effort, buyout firms of the 1980s managed to convince the world to speak as if the leveraged buyout industry had ceased to exist. Even industry critics now talk about it with a less politically fraught phrase, private equity.

Highlight (yellow) - Location 811

In its 390-page 2021 annual report, it uses the word "buyout" precisely once (in reference to management buyouts), and the phrase "private equity" 193 times.

Highlight (yellow) - Location 823

What is deceptive about the private equity brand is the nature of private equity funds' own investors. Private equity funds do not raise much capital from a few wealthy individuals, as once was the case. They raise most of their money from institutions. Each institution itself raises capital from (or holds it on behalf of) hundreds or thousands of people. As a result, the economic beneficiaries of one private equity fund number in the thousands. Private equity funds and firms in no way eliminate the issues Berle and Means raised in 1932. The capital put at risk by private equity firm owners is just as much "other people's money" as it is when invested in public companies. Businesses owned by the private equity industry no more deserve the connotations of "private" than General Motors or Exxon do. Indeed, private equity firms have been growing faster than public companies, and concentrating in a way that public companies are not and have never been concentrated.

Highlight (yellow) - Location 842

Private equity generates more profits for Wall Street than any other industry. In the mid-2000s, bank fees from private equity outstripped the fees from traditional corporate clients.

Highlight (yellow) - Location 855

reported in 1997 that the amount of capital invested in public companies was forty times bigger than in private equity. Today, the ratio is twelve times— an increase of 300 percent in private equity's share. Of the assets controlled by private equity firms, most remain in buyout funds.

Highlight (yellow) - Location 859

Public companies remain the dominant form of economic organization in the US, but companies owned by private equity firms are steadily expanding their relative importance.

Highlight (yellow) - Location 865

Private equity funds exert outsized importance in industries they helped consolidate. In "roll-ups," a single buyer targets an industry, often one dominated by small or midsized companies. The buyer engages in multiple acquisitions, consolidating them into one larger company. Over time, buyers acquire experience in driving down costs and leveraging control and information systems at scale. Such strategies have long been used by public companies. Private equity firms have increasingly used this strategy, which they sometimes call a "leveraged build-up." Having built up a company this way, they then exit (that is, sell the company) as usual. Relying on their strong relationships in credit markets, private equity firms can raise cheaper capital to execute a roll-up than other buyers. Industries rolled up by private equity are even more private equity– dominated than the economy overall. Private equity firms focus on mature and stable but geographically dispersed businesses—nursing homes, housing, food service, and personal service businesses. Small-company roll-ups often avoid antitrust scrutiny, due to the size thresholds in antitrust law. Roll-up buyers can obtain market power within local markets without being noticed as quickly, or perhaps at all, by the Justice Department or the Federal Trade Commission.

Highlight (yellow) - Location 886

Private equity concentration is less dramatic and evident than for index funds, but in some ways, it is more threatening, because of the darkness that is a core feature of private equity, as well as the close connections between private equity and Wall Street, and the high-powered incentives private equity uses to motivate professionals and reshape businesses. Index funds at least report to the SEC and the public about their holdings; private equity funds are designed to be opaque.

Highlight (yellow) - Location 891

Index fund sponsors have also pursued a light touch approach to corporate governance to date, mainly to keep costs low. Private equity firms, by contrast, seek to increase the cash thrown off by companies they buy, and to do so quickly enough to exit at a profit within a few years of a purchase. Private equity firms' cultures vary, but as an industry, private equity is demanding. It is proudly ruthless in how rapidly and powerfully it changes the companies it buys. The firms are more likely to change the ways their companies affect customers, employees, communities, or the environment than companies owned by individuals or families, or mid-twentieth-century public companies.

Highlight (yellow) - Location 896

In addition to becoming more concentrated, private equity funds increasingly cooperate rather than compete.

Highlight (yellow) - Location 906

Club deals can permit collusion— through a form of club etiquette— to keep prices down, particularly in deals to take public companies private. Club deals require close and intimate communication among private equity professionals in particular acquisitions. Over time, such communication provides ideal cover for discussing allocating deals among private equity firms (an antitrust no-no), while creating a false appearance of competition.

Highlight (yellow) - Location 934

Another way that private equity firms routinely communicate— increasingly so— is through what are called secondary buyouts. "Secondary" simply means that one private equity fund sells a company to another private equity fund.

Highlight (yellow) - Location 938

Secondary buyouts pose a puzzle. Private equity advocates long pointed to the shock treatment they deliver to companies, in the form of debt, hands-on governance, and higher-powered incentives, to explain how buyouts add value. But the current owner of a company in a secondary buyout has already applied private equity's shock treatment. Unless the first private equity firm failed to use the private equity playbook, how could a second private equity owner add value? And if the first private equity firm failed to use the private equity playbook, why would the second pay more than the first has already paid? One answer may be that the increase in the number of private equity funds has led them to specialize. Some private equity firms focus on businesses at an earlier stage of their life cycle, others on later stages.

Highlight (yellow) - Location 948

However, secondary buyouts may arise for less admirable reasons. Private equity buyers may be approaching the end of a fund's life. Secondary buyouts may be fast ways to fill out a fund's investment record, generating additional fees. These motives might lead secondary private equity buyers to overpay. Private equity sellers, meanwhile, may provide a quick exit in liquidating a fund at the very end of its life, or to realize profits before a new round of fundraising. Such sellers might be willing to undervalue a business being sold. As with club deals, private equity firms might have informal quid pro quos, sometimes as buyers, sometimes as sellers, to help each other manage fund wind-ups and fundraising.

Highlight (yellow) - Location 957

40 percent of capital raised in the last five years went to just five firms. As buyouts increasingly occur between private equity funds, the firms involved are the largest. They own a disproportionate share of businesses in such transactions. Secondary buyouts are a channel for the industry's growing problem of twelve.

Highlight (yellow) - Location 969

The essence of private equity is that ownership is by entities that are not public companies required to be registered with the SEC and subject to general public disclosure requirements. Yet since 2007, nine of the top private equity firms have themselves become public companies. Starting with KKR and Blackstone, followed by Carlyle, Apollo, Oaktree, Ares, and most recently TPG, major buyout firms have all dispersed their ownership, obtaining the liquidity that stock exchange listing brings, and subjecting themselves to SEC registration and disclosure.

Highlight (yellow) - Location 976

This seems puzzling. How can firms operate private equity funds and yet be public companies? Does the public-company status of large private equity firms solve the problem of twelve they create? The short answers to these questions are that private equity firms and private equity funds differ, and no— the problem of twelve remains intact.

Highlight (yellow) - Location 980

Publicly held private equity firms now report about their advisory operations, the management fees they collect, their costs of fund formation and fundraising, and other aspects of the business of sponsoring and managing private equity funds. But they do not report about operations and activities of their portfolio companies, or details about the funds themselves.

Highlight (yellow) - Location 988

To see how this matters, note that Blackstone's funds own American Campus Communities, Inc., the largest developer/ manager of student housing in the US; PS Business Parks, a large developer of multi-tenant commercial properties; and CoreTrust, a large hospital supply company. Yet investors can find no information about those companies in Blackstone's SEC reports.

Highlight (yellow) - Location 993

The public status of private equity firms lets those firms raise more capital to sponsor more private funds. By disclosing a slice of information about the top-level investment management companies, private equity firms increase their ability to own and control businesses about which they need disclose next to nothing to the public.

Highlight (yellow) - Location 997

Public company status and greater fundraising power has also enabled private equity firms to expand their geographic reach. In the eighties, private equity focused on US markets. Since then, private equity has gone global, bringing private equity techniques to Europe and increasingly to Asia, Africa, and South America. Blackstone's latest annual report touts itself as a "global leader" investing on a "global basis" drawing on "global relationships" in the "global economy." At the same time, it provides no geographic information about its portfolio companies.

Highlight (yellow) - Location 1013

Even if continuation deals are adequately policed, they inarguably demonstrate how the private equity industry has become a separate, permanent governance and capital sector in the US economy.

Highlight (yellow) - Location 1041

Economists Franco Modigliani and Merton Miller earned Nobel Prizes in part for demonstrating that capital structure— finance— should not affect the value of a business, except due to market imperfections. What market imperfections might explain private equity's ability to earn profits? One conventional answer is tax policy.

Highlight (yellow) - Location 1047

Debt is central to how private equity funds buy companies. After a buyout, the funds' portfolio companies have more debt than other companies. Up to a point, debt is taxed more favorably than equity. Interest on debt is deductible, which reduces income tax, while dividends on equity are not. Private equity firms are also paid in part in the form of carried interest, the performance fee that is typically set at 20 percent of profits. Because this fee is based on growth in the value of an asset (a business), it is treated for tax purposes as an investment return. Capital gains on investments are taxed more lightly than ordinary income, and deferred until they are realized in cash. Private equity firms are essentially able to pay themselves (out of fund profits) more cheaply than if they were simply earning advisory fees.

Highlight (yellow) - Location 1058
A second possibility— another market imperfection— is that private equity firms have more information than others. To some extent the skeptical view is right— management buy-outs can be a form of institutionalized insider trading and ethical abuse by managers, aided and abetted by private equity. For a CEO to partner with private equity, borrow to buy his own company from the shareholders he was working for, and then take the company public again a short time later, earning profits far beyond ordinary CEO salaries, still strikes observers as abusive.

Highlight (yellow) - Location 1067

A less damning version of the better information explanation is that private equity firms have better access to market information.

Highlight (yellow) - Location 1071

For example, one study suggests private equity managers are systematically able to foresee comparable public firms' earnings, and to use that information to sell portfolio companies at industry peaks when they have performance fees to harvest.

Highlight (yellow) - Location 1074

To avoid bragging about tax arbitrage or insider trading, private equity backers since the 1980s have told a different story. It is that private equity's basic design produces better management. Through debt, compensation, and governance mechanisms, private equity firms improve the incentives of managers to operate profitably.

Highlight (yellow) - Location 1077

Debt helps not because it is cheaper than equity, or even primarily because of its tax advantages. Rather, sharp increases in debt force companies to improve cash flow rapidly to service that debt, or else. Financial risk elicits a Puritan work ethic. To debt's discipline, private equity's 20 percent upside adds incentives to increase value, shared with managers who co-invest. Tight governance— no large, part-time boards sleeping through glib management presentations before an expensive dinner— enables rapid interventions to keep a company steady in difficulties or amid strategic changes. Together, this package provides shock treatment to mature companies that had been rendered inertial or flabby by complacent, under-incentivized managers. Or they add discipline to second-generation owners of once-thriving family business hampered by nepotism.

Highlight (yellow) - Location 1103

Another, related explanation for private equity's ability to create value is that private equity firms add managerial expertise to the companies they buy. Again, there may have been some truth to this as a general matter in the 1980s, and it may remain true for mid-cap companies that are moving from the founding generation to the next, or that are divisions being sold or spun off by larger companies and are not overseen by managers capable of running an independent company. From the 1990s on, too, smaller private equity funds have specialized by industry, making it possible they might combine change-agent willpower with expertise of value to such businesses.

Highlight (yellow) - Location 1124

Simply put, private equity's primary contribution to US firms today appears to be cheap debt financing, rather than governance, strategy, and operations.

Highlight (yellow) - Location 1146

The bottom line for investors is that private equity investments simply break even. If so, their broader effects on society as a whole become all the more important to understand and assess.

Highlight (yellow) - Location 1153

Even if public disclosure itself creates costs, lack of disclosure can hide, and may well induce, social harms. Hidden information impedes existing competition and reduces entry by new competitors. Consumers pay more in dark markets than in an open market, reducing social welfare. Darkness can hide numerous specific harms that journalists and researchers currently have to spend significant effort investigating at private equity– owned companies to uncover, such as: fraud, poor working conditions, wage reductions, customer overcharges, elder abuse, health-and-safety violations, government corruption, toxic emissions, greenhouse gas emissions, and even human rights abuses. Some of these harms may be the product of negligent or inattentive managers. But some may actually reflect transfers of value to private equity firms or their investors. If so, they are not virtues sensible business leaders discuss in public. If one had to predict private equity's overall social impact, it would also be mixed, and would vary depending on the goods or services a private equity– owned business produces, and how it is governed by law and regulation. Recall that private equity debt, compensation, and governance create sharp incentives to maximize cash flow.

Highlight (yellow) - Location 1188

In terms of its effects on wealth inequality, private equity is simpler to assess. It is an important way that differential access to investment options concentrates wealth over time. After buyouts, private equity firms reduce employment and create significant levels of job turnover, reduce hourly wages relative to revenues, and destabilize communities that are dependent on durable jobs. They

Highlight (yellow) - Location 1202

Researchers have found that private equity buyouts contribute to job polarization— that is, growth of employment in high-skill jobs (such as management and technical positions) and low-skill jobs (such as food-service and janitorial work) along with a decline in middle-skill jobs (such as clerical, construction, manufacturing, and retail occupations).

Highlight (yellow) - Location 1218

While private equity funds do not have the same economies of scale as index funds, massive funds of $ 5 billion or more now make up more than half of private equity fundraising. The largest complexes are growing larger, globally, faster than public companies or the economy overall. They and their political allies wield significant political influence. The drama that sometimes accompanies buyouts, coupled with lack of transparency, make them even more threatening to the American public than index funds. No less than index funds, private equity funds create— and face — a problem of twelve.

Chapter Four: The Politics and Political Risks of the Problem of Twelve (So Far)

Highlight (yellow) - Location 1227

Corporate leaders invested in their own political capital, and applied the resulting power to reduce the constraints of antitrust law, taxation, and regulation, and, most importantly, to lay low what had been one of their most powerful political rivals— private sector labor unions.

Highlight (yellow) - Location 1235

Today, index funds and private equity funds are themselves politically active and influential, and other political actors— civil society organizations, social activists, and political parties and politicians themselves— have responded to these funds' growing economic clout and political power. Index funds have become increasingly politically influential on issues such as diversity, treatment of workers, and climate change, drawing charges of socialism from the right, and of antitrust harm and of dragging their feet on other issues, such as corporate political disclosure, from the left.

Highlight (yellow) - Location 1248

The primary constraints on business are no longer government or labor, but market-aligned shareholder governance.

Highlight (yellow) - Location 1249

Much of government regulation remains in force, if weakened. Workers' compensation, minimum wage laws, and unemployment insurance remain, if effectively reduced by inflation. Workplace and safety rules persist, if erratically enforced. Environmental regulations continue, if only weakly updated to reflect climate change. Corporations do pay taxes, and plan around tax law. Federal securities laws— and the transparency, legitimacy, and accountability they create for big business— remain largely intact as applied to public companies.

Highlight (yellow) - Location 1257

In sum, the policy state for large companies has markedly improved since 1970. Companies are used to winning in the domestic political sphere. At the same time, they lack public trust and legitimacy,

Highlight (yellow) - Location 1261