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BUSINESS PULSE SURVEY: Would you want Patriots coach Bill Belichick as your company's CEO?

Hedge funds give private equity a run for its money

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Even Hollywood wants in on the act.

In the high-stakes investment game, a new group is encroaching on a market traditionally ruled by private equity, and Cruise/Wagner Productions, movie star Tom Cruise's production outfit, is among those that have secured financing from highly capitalized and comparatively more fluid hedge funds.

"The phenomenon that we're seeing is that hedge funds have an enormous amount of capital and they have to find new ways to deploy it," said James T. Barrett, a partner at Boston-based Edwards Angell Palmer & Dodge LLP. "They've done so in the private sector competing with venture capitalist funds and private equity."

Globally, hedge funds are valued at about $1.225 trillion, according to Hedge Fund Research Inc., up from $539 billion five years ago.

"Hedge funds were traditionally small," said Matthew T. Henshon, a partner at Boston-based Henshon Parker Vyadro PC. "As they've gotten bigger now they have the size to take out a company."

In the current investment climate, fledgling and midsize companies are going after private investors as backers, and major investors are seeking higher returns than available on the stock market. Hedge funds, once focused solely on public stocks, are now doing private deals and yielding quicker returns than those offered by venture capitalists and private equity funds, which typically wait up to a decade to net a profit.

"A hedge fund is fast food," said Carl Stjernfeldt, a partner at Wellesley-based Battery Ventures. "Venture capital is a long, slow dinner."

Hedge fund managers trade within months and sometimes even within minutes or days without getting involved in company operations -- unlike venture capital funds, which often put a fund manager on a portfolio company's board. Because hedge funds have the potential to provide high returns quickly, the lines are blurring between investments, say experts.

Helping to boost this phenomenon are low interest rates and high confidence levels, said Matthew Bishop, bureau chief for the New York office of The Economist magazine.

"The broad backdrop," he said, "is there's a lot of money around. It's a very loose credit market right now. There hasn't been a bank failure for quite a long time in the major markets. Interest rates have gone up a bit but they're not outrageous. ... You have this shift from investing in the public markets into private markets like hedge funds and private equity."

A survey released this month by the Association for Corporate Growth and Grant Thornton showed that 91 percent of private equity professionals and 87 percent of hedge fund managers said hedge funds will increasingly invest in private companies.

"The convergence trend is driven by hedge funds looking for ways to put their growing assets to work across a wider spectrum of financial opportunities, boost returns and diversify their risks, and private equity firms seeking ways to attract more capital and realize gains on a more current basis, rather than waiting for portfolios to mature," said Daniel A. Varroney, president of the Association for Corporate Growth. "The effect is more options for buyers and sellers of businesses and additional partners to co-invest with, but also greater competition and higher prices for acquisitions, which could have a negative effect on returns."

The fund weighted composite index of Chicago-based Hedge Fund Research shows a five-year annualized performance of 8.7 percent. Venture capital funds posted a 19.8 percent return for the first quarter of 2006, and a five-year performance rate of -4.4 percent, according to Thomson Financial's U.S. Private Equity Performance Index. The private equity return numbers reflect the dot-com crash earlier in the decade and the economy's continuing recovery. Despite the long-term negative returns, more than 500 U.S. deals worth $157.4 billion were backed by private equity firms during the first half of this year, according to San Francisco-based CBS Market Watch.

"During the bubble, there were firms that generated returns of around 500 and 600 percent," said Stjernfeldt. "It's great fun while it lasts ... then life goes on."

But Stjernfeldt said the venture capital market has improved since 2004, when his firm began backing Broadbus Technologies of Boxborough. The tiny firm consisting of two founders, produced an on-demand server for cable television. Broadbus was acquired two years later by

Motorola Inc. of Schaumburg, Il., for a "nice return," said Stjernfeldt, who wouldn't release financial details about the deal.

Hedge fund managers by and large try to stay under the radar screen. One exception is the Cue Ball Group of Boston, which rolled out the Cue Ball Discovery Fund in July, a fund-of-hedge funds that targets hedge funds with smaller asset bases -- $300 million and under.

According to the fund's portfolio manager, Brad Balter, an advantage of hedge funds is their flexibility to bet on stocks when prices go down, making them "theoretically" able to profit "in an up or down market."

In July speculation was flying over which hedge funds were backing the production company of Tom Cruise after his much ballyhooed parting with Paramount Pictures. Though Cruise/Wagner Productions was looking for $100 million, current reports say the company came up short. A partnership for the Washington Redskins gave Cruise less than $10 million.

But you can't blame company officials for trying.

"Not only do (hedge funds) have more money, but there's more activity in the private market," said Barrett. "There are juicier private deals. That's a fact."

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