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CAN AMERICA GET ITS ENTREPRENEURIAL GROOVE BACK?

A DISCUSSION ABOUT PRIVATE CAPITAL'S ROLE IN THE ECONOMY

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PANEL ONE: THE STATE OF PRIVATE CAPITAL AND ITS FUTURE POTENTIAL

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MR. BAILY: Okay. Thank you. We're going to look now at the state of private capital and its future potential. I'm going to just start us off. I'm then going to hand over to Ronnie Chatterji, who is an Associate Professor at Duke University in the School of Business; done a lot of work on the issues that we're talking about today: venture capital, angel investing and teaches a lot of courses in that area.

I'm very pleased to welcome Michael Klein. He was one of the pioneers within Citi in setting up a private equity group. He's now the managing partner of Invest America. So, let me just start off, and then I will hand off to these folks to talk some more about the issues.

Just to sort of set the stage in the beginning, we've had a real estate fueled bubble, a real estate fueled recovery. We've now sort of got to look somewhere else. I don't think real estate is going to carry us back to the kind of growth rate that we've had in the past that we need to get full employment back in this economy.

As you see from this chart, investment is growing so businesses are investing, but certainly not at the same level; we don't have the same level of investment. So, we need sort of a shot in the arm, in terms of investment in capital formation to contribute to recovery.

One of the things that characterizes the success of the American economy has been the number of new companies that are formed. There are different ways to measure this. It's a tough thing to measure, but this chart shows how the rate of new private sector establishments are being launched every year from 1993 to 2010, and you can see it goes up and down with the business cycle. It's taken a very big hit in this recession and has not yet really come back. So, that's the second thing we need to get this economy going again, is that entrepreneurship, that ability to form new companies. Many of those will fail, but some will succeed and some will grow and provide a lot of new employment.

So, that's the sort of context in which we want to talk about; the potential role for private capital. Can it help in getting investment going again? Can it help in entrepreneurship, new companies? And there, I think, is where I will turn it over to Ronnie. Thank you.

MR. CHATTERJI: Thanks, Martin. And I'll talk for about 10 minutes and then hand it over to Michael Klein. We were all in the 55 percent of the 18-month olds who were able to work together, so it's been a really great process working with both of them on this project.

So, what we want to do today is facilitate a discussion about the role of private capital in the economy and how it might drive economic growth. And when we think about private capital, there are a few different categories that we're going to discuss today, and these categories aren't necessarily mutually exclusive in all cases.

So when we think about angel investors, we're thinking about wealthy individuals who typically invest their time and money in nacen ventures. Really, it accounts for around $20 billion in 2010; a very small amount of money compared to the rest of the capital structure here, but in many ways, very, very, important to the ecosystem in trying to get entrepreneurs started.

Venture capitalists are much heralded intermediaries who channel investment, private capital to start up companies, and they had $167 billion in what they called dry powder to invest at the beginning of this year.

There's been a lot of talk about corporations, a lot of news coverage on cash-on-hand and why corporations are holding $1.9 trillion on their balance sheets. We're going to talk about that a little bit; private equity and sovereign wealth funds, both imported and financial investors, as well. Michael will talk a little bit more in detail about that.

The big question you want to think about here is -- you know, you look at

these sources of capital. What are the challenges in terms of unlocking these and channeling them to productive investments? Martin set the stage by giving us a sense that the last decade was characterized by a booming investment of real estate, and it turned out not to be a sustainable foundation of growth. What we're trying to do here is think about how you might channel investment from these sources to more productive and sustainable investments.

So, you know, when I worked for Carl Shapiro -- he's here in the audience -- at the Whitehouse, we looked at a lot of the policies around the world to encourage entrepreneurship and innovation. And I think what everyone in this room knows is that other countries are not standing still when it comes to encouraging their entrepreneurial ecosystem. So, if you go to Chile now, they have a program called Startup Chile, which is trying to attract entrepreneurs to locate in Chile. The have programs in China and India to attract returnees, people who have come to the United States and the U.K. to come back to China and India to start new businesses.

There are also concerted efforts to develop intercapital markets. If you read Josh Learner's book, very few of these have actually been successful. Israel is profiled in the book. Start-up Nation might be one example of that.

There have also been efforts to try to revive the small cap IPO market. In London they have the AIM market which has had some limited success, so far. And, as a result of this sort of foreign competition there have been numerous calls to refine U.S. policies in this area. And it really goes to what David Brooks has talked about and Josh Learner has talked about in his book, which is what is the function of government?

On one hand, you have the table-setting approach, which is, you know, low and stable tax rates and effective immigration system that brings high-skilled people here to the United States, strong intellectual property laws, and developed and robust financial markets. And I use a much less elegant term than Josh to describe the other

function. Maybe this is on the 60- or 70-yard line, which is, instead of setting the table, should the government be cooking dinner. All right?

So, on top of the table, you think about the Government providing venture capital, low cost loans. You hear a lot about this with the Department of Energy loan program in particular, but a lot of this is also coming from other countries. If you look at what Chinese banks are doing to support their green energy producers, it's much more in the cooking dinner category than it is setting the table. So definitely an interesting debate that should be had today on what the right role for public policy is. Even if we're between that 40- and 60-yard line that David articulated, what is the proper role for government in trying to harness these sources of private capital?

Let me talk a little bit about the sources in detail. So, if you look at angel investing, typically these wealthy individuals, sometimes they'll be accredited investors by the SEC; sometimes not, you know, only $20 billion. So, you might think this isn't very important as part of the larger picture. But if you look at the amount of ventures they actually touched the best data we have says they touch about 61,000 ventures per year.

To give you a sense of magnitude, there are about 600,000 businesses founded in the U.S. every year. So, 61,000 is a considerable proportion of that; 370,000 jobs attributed to angels. They're also widespread across industries. This is not a narrow phenomenon in one or two industries. You’re looking at healthcare, devices, biotech, software, a wide variety of industrial sectors where angel investors are having an impact.

I think, to Joe's point earlier, and Josh's work on private equity, there's not a lot of good data on angel investing. It really only comes from one source, and we need more rigorous data to figure out how we're going to think about policy in this area. It hasn't stopped 26 states though. They have angel tax credits to incentivize angel

investment. And, you know, in our work, in our research, we haven't found any examples of cost benefit analyses on these angel task credits; so, very interesting policies, but really haven't been analyzed to figure out where the bang for the buck is.

The other thing that hits angel investors quite a bit is the accredited investor rules under Dodd-Frank. There were recent changes now that have been rolled back that made it more difficult for angels to qualify as accredited investors and they actually raised a lot of concern about that. So those are the two policy areas, I think, to look at when you're thinking about angels: the tax credit side and the definition of accredited investors.

Now, venture capital is a story that people know a lot better. And instead of putting a lot of words on the slide, I thought I'd show you this chart, which kind of tells you the story of the last generation of venture capital.

So, of course, we had a big boom in the late 1990s with the internet bubble, and people are well familiar with the great companies. It seemed at that time, if you had dot com in your name, you could actually go public and, apparently, people thought you had a reasonable business model. Well, we found out that wasn't true. And now venture capital, in terms of amount raised, is quite a bit lower than it was and it hasn't recovered to it's pre-2000 level. But there's a question here when you look at this data, and this is where I think the academic research that Josh and other people are doing is really important.

So, if you look at what's challenging in the venture capital market, one thing you'll hear from the VCs is, "Well, the way we make money in venture capital is through exits. We invest in companies and then we have a liquidity event; typically a merger and acquisition or, hopefully, an IPO. And often, it's that one company out of the 10 in the portfolio that goes public that justifies the entire investment."

So, if you look at what happened in U.S. initial public offerings this is

actually the real story of venture capital from their perspective. And you look at, again, after a boom in the late 1990s and 2000s, the IPO market hasn't really recovered. And this is something that predates the Obama Administration and begins way back in 2000.

So, one issue for VCs is trying to get a return on their investment. If the IPO market is weak, if not enough companies are going public, then the venture capital business model is threatened and that's causing a lot of interesting changes in the industry and a lot of calls for changes to policy.

So, one of the things that the VCs will often tell you is that there's barriers to going public and they often point to the villain of Sarbanes-Oxley, in particularly, 404(b), which has to do with internal audit controls. Maybe we can talk about this more in detail later, but this is the most frequent refrain that I hear.

If you look at the statistics, the average age at initial public offering has gone to about 10 years as opposed to seven years. Typically, venture capitalists were organized into partnerships that last between, let's say, five and seven years, might be more difficult as these companies get older before they go public and can get liquid.

You know, there is also a lot of policy uncertainty that VCs are facing. One of the things has to do with FDA regulation. If you talk to anyone from the biotech or medical device sector, they'll have a lot of concerns about the FDA process and how quickly they can get products approved.

Essential to their business model is getting products through the pipeline very quickly. In pharma now it takes a long time. Medical devices are often ahead of 510(k) process where you can get products to market much more quickly. That looks like it's going to change. There's a lot of concern around that.

Also, on cleantech and the lack of a price on carbon; without a consistence or policy towards energy, a lot of venture capitalists are unsure about how to invest in this section and it's caused a lot of concern.

And the one you hear most about, which really surprised me, I think, when I went to Silicon Valley and talked to people in North Carolina, is immigration. That often comes before these first two. Venture capitalists, especially, are very concerned about trying to attract the right people to this country and keep them here. So, policies like stapling a green card to people who get PhDs in stem areas, trying to have a startup visa to encourage people who start companies here that stay here, these are high on the agenda if you talk to a lot of VCs.

One thing is that, you know, not all venture capitalists are actually doing badly. There are a few top firms that are actually doing really, really well. The problem, as it were, is they're actually getting bigger. They're raising larger funds and moving much more towards less risky bigger staged products, so there's a lot of worry that we might see less investment in the early stage capital.

And so, for the Hamiltonian vision that David Brooks articulated, you really need to have providers and capital for those early stage investors, the person with an idea, right? And these guys tend to be moving up more towards the middle range, and that's causing a lot of concern as well.

There is also this issue about how big the venture capital market should be. I showed you that chart about the number of investments and about the value of investments. But Josh Learner, in his work, has actually looked at this and calculated the percentage of VC compared to the public equity market. So, if you look at that, the proportion has actually been quite stable over time. So, we can't look at the size of the venture capital market in isolation; we have to look at it in the context of other capital sources, and that's a really important point to make.

The other point I'll spend a little time on is the cash-on-hand issue. If you read the paper over the last year, you'll see a lot of concern over what do we attribute this corporate cash buildup? Where is this $1.9 trillion coming from and why aren't

companies invested? And I would think there's two camps, really, when you think about the reasons. One camp said it's all about policy on certainty and regulatory overreach. In the way of Dodd-Frank and the Affordable Care Act, companies, as the story goes, are afraid to invest because they don't know what the regulatory environment is going to look like; that's one hypothesis.

On the other side -- and this comes more from folks who subscribe to the Keynesian School of Economics, would say, "It's really about uncertainty about demand. I won't want to invest unless I know there are going to be customers with money in their pockets to buy my products." So there's lots of different ways we can look at this, and this is a great discussion to have.

One way might be a look at which firms are holding the cash and if they are in highly regulated industries. A quick cut of the data suggests it's mostly technology firms that are holding on to the majority of the cash; companies like SISCO and Google and eBay, rather than firms in what we might think of as highly regulated industries; lots of ways to look at this data and think about it.

You also have to look at borrowing costs. Borrowing costs are at an all-time low, so a lot of the cash-on-hand has been stockpiled by borrowing at low rates, and that's another thing that's really driving that up as well.

Now, the cash-on-hand has led to a lot of policy proposals from congress and others out there in the think-tank world in terms of how to harness that cash towards investment. The biggest idea has been around repatriation of foreign earnings. One idea is going to model this after the 2004 American Jobs Act and the Bush Administration and tie repatriation of cash offshore to productive investments here in the United States. So, this is one creative way to try to channel capital on companies' balance sheets into productive investments.

The 2004 experience was not very encouraging. Most of the money from

this ended up going into dividends and shared buy-backs. And so, when you're thinking about policy design you need to make sure you have a mechanism in place to try channeling the investments to productive sources.

Corporate tax reform, again, is going to be a huge issue in this area. Most people agree we need to broaden the base by gaining real loopholes, and also make sure that we lower the rate, and that will be more competitive. Right now we have a 35 percent rate but it's like Swiss cheese where very few companies are actually paying that, so it's a really interesting point to look at how to do that.

The Obama Administration has done things on bonus appreciation, also, 100 percent expensing on capital investments to try and encourage companies to invest some of this capital.

So, private equity I'm going to leave to Michael. He's the expert who's worked in this industry for a long time. I think he's going to talk a lot about some of this controversy about private equities impact on the economy. There are a lot of things being thrown around, a lot of data being thrown around about what PE firms do, what the model is and what the impact is on jobs and productivity. Michael's going to talk a little bit about that. The sovereign wealth fund issue, also, I know Michael will touch on a little bit.

One thing to remember with the Sovereign Wealth Fund is they're getting a lot of attention recently. It's really the top six funds that hold 75 percent of the assets. And even these top six funds are very diverse in what they invest in. So, thinking about sovereign wealth funds as one thing and one monolithic entity is probably not correct. These funds have very different missions, very different goals and very different restrictions on what they can invest in, also very different rules around transparency, which is one of the things that's been concerning policymakers for a long time.

The other thing, I think, to hit on later in some of these discussions on

sovereign wealth funds -- we all remember the Dubai Ports World issue when there was a potential investment and there was a lot of concerns raised about national security.

One of the biggest issues when you have a foreign investment in the United States is what they call CFIUS review to go through this process. And policymakers are often reluctant to approve foreign investments in what we consider critical infrastructure. That's one potential barrier to the deployment of private capital. If sovereign wealth funds have, you know, $4.7 trillion right now under management, they might want to invest in some of these infrastructure projects, but CFIUS review and other issues might make that more difficult. So, we need to think about how to come to common ground on that, as well. I'll let Michael talk about that in more detail.

So what I'll leave you with is this: I think there are a few open questions to consider as we think about whether private capital can lead to sustainable and productive growth. One is that, can it do more? Right now we think about some of the advantages in private capital as not being sort of straight-jacketed by the quarterly earnings pressure that you often see with public companies. The question is, if you look at angels and VCs and private equities and sovereign wealth funds, can they actually do more than they're doing? What kinds of policy instruments can actually make that happen?

However, I think you have to return to David Brooks' point about table-setting and cooking dinner. In our efforts to try to harness private capital for the common good, we might actually end up channeling into unproductive investments, wasting money, end up raising the ire of the public in terms of these investments that we make. So, I think the discussion today might want to focus on this, in terms of whether these interventions to channel risky capital into the common good might actually backfire, and how do we achieve that balance; I think that's the key point.

In terms of whether America has lost its entrepreneurial edge, I would just

push people here to think about how we measure this. I mean, it's really great to think about big companies and IPOs. How do we want to measure America's entrepreneurial energy? Is it by the number of companies founded? Is it by the number of big billion dollar businesses founded? Is it the number of jobs? I think that that is sort of an important metric to think about when we think about where we're trying to go. We need to have a vision of what we're trying to do with private capital if we're going to know how to get there. I would encourage us to think about these questions as well.

So, why don't I stop here and I'll turn it over to Michael Klein to talk about some of the other issues at hand here.

MR. KLEIN: Okay. Well, thank you very much, Ron. I think, under the spirit of teamwork, I'm hopeful that you'll see the questions that Ron has posed flowed neatly into some of the answers that we'll attempt to address right now. Let me thank Martin and Joe Rice for inviting me.

As Martin indicated earlier, I spent a large part of my career, probably 10 or 12 years helping to establish a process of, if you will, advising or allocating private equity, the breath of capital from venture capital to late-stage leverage buy-outs into what was a productive force for both investors and for corporates.

I've been a bit removed from that over the past several years as I've spent the bulk of my time working with governments on restructuring activity, which seems to be quite active, in particular, starting with the U.K. bank recapitalization scheme. So, I'm pleased to have a chance to have spent some time reengaging in this sector. And hopefully, today, we'll be able to look at some of the questions that Martin has asked me to address and try to give a sense of perspective.

And really, the questions that have been put forward are the five that are listed here. First and foremost is, is there a shortage of capital today? I think, when one looks at the allocation of capital, you'll have to start with the question of the quantum.

Are the markets working to address and migrate that capital to growth? Are there fundamental structural impediments? And I think we will spend a fair bit of time on this question that David Brooks has set forward, Josh has put forward, in terms of table-setting: where is the Government's role.

Is private capital part of the solution and what actions can be taken? I'm going to start by saying I'm actually quite an optimist here. And I would say, whether it's just returning from trips to Silicon Valley or, frankly, from Houston where Shell gas is changing the industrial competitiveness of the United States. I have a much more optimistic view of the state of the U.S., of the state of private capital and, frankly, this government and corporate and investor balance.

But, since I was coming to Washington, and since I thought I needed greater expertise, I checked the President's State of the Union to take a point of view on what was going on, and I looked -- and as you'll see, I chose not to look directly at the latest State of the Union, although, the first 10 or so points looked remarkably similar.

The unemployment is higher than we'd like. The extension of national insurance coverage, passage of free trade agreements; all this sounds pretty similar to the position we're in today: significant infrastructure investment, focus on balanced budgets, a real focus on exiting government from business enterprises, a new SBA program, $31.5 billion. And if this slide had faded in the way I had anticipated, you would've seen this and seen the last two points and said, "Well, is he a prognosticator or just a real optimist? And that is the largest tax cut in history and a 25 percent growth in GDP."

The point of this slide was to indicate that, actually, virtually all of the policies at the top of the page are policies that you could have read about in the newspaper over the past several months and associated it with this administration. But, in fact, this State of the Union was from Dwight Eisenhower's State of the Union. And I

point it out not because Karen Mills, who's a good friend, will be here with her focus on the SBA, not just because we have a member of the Council of Economic Advisors -- both of which, I remind you, were either started or restarted by Eisenhower -- but also this focus on a dichotomy; removing government from commercial industry, but inserting government in the creation of infrastructure, inserting government into the creation of better business practices, in particular, mentoring and creation of a sustainable small business population that could operate at the same levels as larger businesses. I think that balance is not only critical, but I think that balance will be an important factor in driving success, going forward.

So, as I jump in, I think it's important when we look at this question of where are we vis-à-vis, capital, to remember where we've come from. Pre the crisis, we had unprecedented liquidity.

I point you to just one or two numbers. There's $7 trillion of capital raised annually as of 2007. That's about 20 percent of what was the relevant GDP in those markets. That's an enormous number. Clearly, that fueled the global expansion. It fueled growth of over five percent in 100 countries. It fueled record growth for four out of five years. It took a tremendous number of individuals out of poverty in emerging countries. It created, fundamentally, great stability and low perception of risk in the marketplace.

But I think the area that I would really focus you on is, at every point of a recession or economic challenge -- whether it was '81, whether it was '87 to '89, whether it was 2001 -- the path out of that recession involved a substantial raising of capital and the substantial uses and deploying of capital. So, the question today is do we actually have enough capital to drive out.

Now, to remember the state of 2007, so we can understand where we are today -- and I view it this way because I think every investor, every corporate CEO,

every executive is looking through a window, which is called a financial crisis window. When the August market shivers came, it came largely because of a question was asked, "Are we acting like 2008 again?" We have a commodity price increase deflation. We then have a banking crisis; Europe, not Lehman. Will we have the industrial shut down? This crisis window is the path that we're all living in.

Pre-crisis, we had this degree of stability. We had China in the form of industrial enterprises putting capital into the market. We had metals, mining, oil, gas funds circling into the capital. And at our bottom box, the U.S. and Europe kept pace through financial mechanisms: leveraging of banks, creation of structured vehicles, continued development of financial mechanisms to keep that world spinning. And of course, that world spinning created great liquidity. And then the bubble burst. And when the bubble burst -- and this is a painful reminder, I think, for everyone -- but when the bubble burst just in the '07/'08 period, we had approximately five trillion of capital exit the system.

I put this number out because when you consider the seven trillion being raised per year, five trillion coming out of the system in one fell swoop, it's really no surprise that we had the shock that we had. We took almost a full year of capital out of the system. It should be no surprise, then, that global trade -- which in 2007, had approached $11 trillion -- dropped by 80 percent in the next year. The world simply ceased. Capital stopped flowing and the world stopped producing.

So, why is that? Well, in part -- and I'll come to private capital in a moment -- but, in part, it's because the financing markets are a continuum. Central banks can create money, but they rely upon a system to extend that money. Universal banks at 15, 20 or 30 percent, 30 times leverage, funding brokerage firms at 30, 40 or 50 times leverage. Funding investor and investor vehicles means you are dramatically multiplying the base capital into the system. And in times of stress, as we saw in the

market crisis, the entire middle shuts. And when the entire middle shuts, whether it's interbank lending, whether it's leverage, you essentially have one provider of capital -- that's the central banks -- and you eliminate all of the money multiplier impact; and that's what took place.

Now, the good news is that took place. And the good news is the financial entrances were replaced essentially with the bottom box; central banks, governments. I lived through the U.K. bank recapitalization's scheme and that was an incredibly bold move on behalf of Prime Minister Brown and it was followed up by bold moves around the world, and it's still, frankly, being followed up in Europe as we speak today. But that extra part of the stool, that extra ballast was required. But what it means -- and it is a fair question to ask -- whether it's the 40-yard line, the 60-yard line, tables-setting or dinner-cooking -- you have now governments with a dramatically different seat at the table, by definition, because of the capital provided.

But to the question of, do we have enough capital; actually, we have more capital. The reduction of rates, the creation of new monetary stimulus has actually increased the capital raising since the crisis. We've seen significantly more capital raising. And by the way, to those focused on financial engineering and the perils of which there are, financial engineering and financial technology also continues to grow -- as you can see derivatives of -- continued to grow, despite the crisis.

Now, if you take Mackenzie's data, it isn't just the annual capital that's raising. The overall financial stock has increased and increased substantially since the crisis. And 2010 was the first period where we saw the financial stock grow. Capital is available. And for those companies that can raise it in size, it's at historically low nominal costs and valuations have recovered significantly. And that period of shock which drove risk up three- or four-fold -- as measured by things like the VIX index or spread -- those areas calmed dramatically to a period of greater stability.

The problem, though, is it hasn't flowed evenly. The problem is that the majority of the fixed income that's been raised, which is about half of this capital growth, has been government financing; over 80 percent of the fixed income raised. So 80 percent of the half of the growth has been government financing.

Over 80 percent of the remaining, which is equity, has come from emerging markets; 60 percent of that's China. And, in fact, what we have with these numbers is a masking in that you've actually seen more growth in areas that have grown and more shrinkage in areas that have shrunk. So, China has seen a $2 trillion growth in fixed income, and financial players in the western markets have seen a $2 trillion shrinkage in the western markets. So, capital in absolute is greater; capital in the places that we are seeking to promote growth is decidedly less.

One statistic that I just found interesting -- if you take out Fannie and Freddie, the actual securitization market which fueled a lot of the U.S. has dropped 83 percent from the crisis to 2010.

Now, where are we? Were we are is that the process of funding is still under stress, and all of the boxes on the left remain in some degree of stress. Central banks in some areas have provided to the limit of what they can do. Banks continue to de-lever. Brokerage firms, in some cases, have been merged, replaced, put out of business, created into holding companies, and the net result is the question that was put forward by Ron. You've got investors that are sitting on significant capital through savings, and you've got corporates that are sitting on significant capital. And those two items in this domestic market are quite notable.

I would say that, by the way, the China numbers of 60 percent of the equity of the bulk of the IPOs of $2 trillion worth of debt raised are on top of China increasing the government stimulus from 42 percent of the economy to 53 percent of the economy. So, it is not as if those areas were what was necessary as much as what was

attractive.

So, to the question, is the model broken or is the model able to work? I'd say one of the big problems that we have to recognize is, it isn't just the crisis, but the pre-crisis model. We had a bit of a buy versus build, not just consumption on a personal basis, but on a corporate basis. And the reduction of equity that occurred between 2004 and 2007 in the U.S. and in Europe was a function, if you will, of a buy versus build value equation. It's no surprise that if you've got four or five times the amount of MNA that you have research and development in the United States, you have a fundamental difference where the creation of value from growth is different than the creation of growth for growth. So, this system is a system that underpins part of the question as we seek to readdress and adjust going forward. But, by the way, that's really what private equity was created for.

So, if I go back to my Eisenhower period, the launching of the SBA, the launching of significant changes to investment rules that all occurred in the late 50s to build what became the institutional private equity industry from 1970s onward, this industry has filled gaps that have occurred in virtually every traumatic period or in every period where growth is required. And the spectrum that private equity plays is a spectrum from a very early stage, as Ron described of angle, all the way through until late stage, in terms of restructuring challenging business.

Now, it's a pretty natural model. And while it's fair, as David Brooks has indicated, that this will come under great debate -- in particular, with Mitt Romney's campaign -- it is a model that is born from a very rational and, I think, very logical and very appropriate approach. And it comes from, in my own view, two distinct processes that were good but not perfect.

The old industrial conglomerates which took the view that I could extend broad-based management across multiple industries worked, but didn't work necessarily

to direct incentives of the largest managers to the smallest divisions. And by the same token, mutual funds, which democratized capital, also removed, if you will, some of the direct imposition of owner culture on managed published companies.

I would say, by the way, that we've gone well beyond that with index funds, and we've gone even beyond that today with high frequency trading. And today, 80 percent of the volume that goes through inequity exchanges are high frequency trading or index funds which are not taking any investment decision whatsoever, other than that as arbitrage or computer generated.

So, the need to have better management and owner culture is really where private equity excels. Mark Wiseman is going to speak later and I'm sure he's going to give a great view of this because he's seen it and he's dissected this well. But I break it down into having the ability to bring stronger management teams, have interest aligned, have efficient capital structures and tax strategies, but more importantly, private equity is flexible activist fiduciary capital. They take a long-term view because they have long-term money. They have the ability to take a long-term view. They have visibility across the whole spectrum of opportunities, and they have multiple paths to exit to create value.

It's not simply public company shareholders who can only sell their shares as a vote of exit. They have the ability to merge companies, change management, add on businesses, invest in new plants, invest in new technologies, invest in geographies.

IPO recap; they can go any route because they control that, and as such, they have a control premium. And it is a survival of the fittest industry; make no mistake about it. The statistics show very clearly that the top performers generate all the returns in the industry; all the returns. Josh Learner will discuss that. And in addition to that, if you can’t make it past a second successful fund, you’re out of the industry. It is a very survival-focused industry.

But, this industry and this model allows for things that can't work in the public dynamic. Joe Rice's firm, CDNR, converting IBM typewriter business -- which, by all rights, could well have gone out of business to Lexmark's printer business -- could not have been done in the public domain, just as -- without speaking with any direct knowledge -- it's impossible or has been impossible for Kodak to change its business model in the very same way. Private models allow for this to have taken place.

Now, in addition to that, we've seen phenomenal -- and by the way, if you haven't been out to Silicon Valley lately, it's another world and you'll feel far better if you go. You can't get into most of the hotels, but if you go, you'll find that it's a much different world; and why?

Now, there's there a study -- there's many studies. This one happens to come from Global Insight, which is a company I'm on the board of -- and I can't speak to the data fully, but I can say that when -- there is a discussion of 4,000 venture-backed companies, three trillion of revenues which is, at this point, 20 percent of the U.S. economy -- revenue growth of nearly twice what was the average company and 12 million jobs created, including venture-backed companies having 50 to 80 percent of some of the highest growth industries. It's a fairly phenomenal track record and it's a fairly encouraging set of statistics; and this is 2008. This isn't the 1998 to 2001 bubble. This isn't the 1984 micro computing. This is late in the dynamic of this definition.

Now, late-stage private equity as well, by the way, will show statistics, and you'll see it from some of the research that Josh had put forward that they create value not simply through what is the perspective of leverage, or the leveraging of the S&P 500, as has been described, or asset stripping. Half of the returns are sales growth. A piece of the return is a reduction of debt and a piece of it is multiple creation. There are multiple studies. This is just one study that was done by BCG.

There are other studies. One study shows very clearly revenues growing,

margins growing, and employees -- and in particular, employees were there where industries that required cost-cutting going into the investment. The reallocation of capital into the better sectors within those portfolios drove growth and growth in capital, capital reinvested in expanding these employees. This is, I think David Brooks indicated, is going to be a very hotly debated subject as the ongoing election campaign comes forward. I think more data will come forward and the data will be, I suspect, on both sides.

But the real focus will be driven by what is the perception of private equity, which occurred in 2006 and 2007; very large companies, very large LBOs, a return to what had become the initiation of the LBO industry of RJR Nabisco; a return to the days of very large company transactions. That was a very brief window, but that brief window gave a sense of this buy versus build culture permeating the private capital industry. But I would argue that even before that the battle lines were being drawn; even before that.

The first set of unions in 2006 were raising the question of wages versus profit margins for large companies, even before the large LBOs. From the U.K. and Europe and the U.S., there was a discussion of wealth creation and carried interests and all elements like that, so the battle lines were drawn and the battle lines continued, and this debate is a debate that requires very good analytics. And my perspective, in the data I've seen, show quite clearly value creation, flexibility, long-term investing. Now, by the way, a big part of that is the broken nature of what is the public capital market.

As I said, when 80 percent of investment decisions are not being made for what are direct directed capital allocation, you have a fundamentally different market. Short-termism in the public market makes it that much harder to take actions.

We've seen and saw, during the period of the 1970s onward, an outsourcing of R&D from corporates to the venture capital industry, and this is a part of

what has become a continuous path towards public market short-termism.

But let's be clear; private capital is not an eleemosynary set of institutions; they will follow returns. So, the question of this capital and the capital that's available has been estimated -- the dry powder that Ron's number showed about $1 trillion -- there are estimates that range from 750 to somewhere north of one and a half. It's about 15 years of IPO capital. It's about 15 years at the current pace of IPOs. It's a significant amount of capital. Where that capital is utilized is going to have a massive impact on where growth is found. So, will it be attracted to emerging markets? Will it be attracted to distressed debt? Will it be attracted to growth capital? What will encourage that? What will encourage that is the expectation of returns.

If I have one small comment I would make, it is, though, that private equity -- and this will be a question as part of the image -- has not yet established itself, despite the business model, as having the same sustainability that industrial companies and industrialists had in creating value during economic challenges. You only need to drive to Hershey Pennsylvania or to Midland, Michigan to see the impact that Milton Hershey had in a period of the Depression where one could buy assets cheaply, put labor to work, build both schools and build what were whole communities for that company.

You only need to go to Midland to see the same thing for Dow Chemical where both of the high schools are named either Dow or Chemists, and all of this is based upon the formation of what was local.

Private equity is a global industry, and the question of private equity's impact on society is a local question. And the definition of what is created, in terms of this image, and whether Texas Pacific Group or KKR or Blackstone can have the same employment standards and training standards and exit standards that GE prides itself is a question that will be raised and will be raised importantly.

Let me close out by saying private equity strategies are being adopted globally. It is one of the great technologies that has been created in the United States and extended. You clearly see, in many countries -- and I would point to Russia in particular. Russia has recently announced and gotten great profile for a $10 billion fund, half from private equity players, half from their own coffers, all focused domestically on creating the economy. The same thing, by the way, is true in other FDI encouragement programs. It's true for U.S. corporations in Saudi.

Despite what is a phenomenal opportunity -- rightfully so, with Shell Gas creating increases in the Gulf Coast -- one of the biggest joint ventures announced in the past several years was announced between Dow Chemical and Saudi or AAMCO in Saudi, with the provision of both capital and energy resources to build a full petro chemical complex, the biggest in the world.

Now, these sovereign wealth funds are not just building at home; they're going abroad. It's inevitable. We have to recognize that these providers of capital, and the state-owned industries that are linked -- it is inevitable that the flow will come.

We have to recognize not that there is an IP question, which there is; not that there are other issues that should be faced, which there are; not that there are transparency questions that shouldn't be raised; of course there are. But when you have the three biggest banks in China, all being two to three times larger than the biggest banks in the U.S., Europe and the U.K., you recognize that they will go outbound with their companies to expand globally, just as the Japanese banks did going back three decades ago. This degree of inevitability means we have to find processes that are constructive for growth on all sides.

I'm more positive. I think I'm more positive because -- first and foremost, to the questions that were put forward by Martin for me to answer, is there a shortage of capital today? No; I don't believe there is. Are the markets allocating capital to growth?

They are, but not necessarily in all the areas we want them to be. Are there structural impediments from the crisis in response? I think there were structural impediments before, and I think those structural impediments are outweighed by the structural benefits of the flexibility of our capital markets and by having great ability and speed to adjust.

Is private capital a part of the solution? It is, has been, was, and for four decades, has been a critical partner to other government solutions. And what actions can be taken? I actually think a lot of the actions are already occurring.

I was fortunate -- and when Karen Mills stands up and speaks, she'll discuss her Startup America program. We were fortunate to create a fund called Invest America which will, on a state-by-state basis, create jobs -- purely a nonprofit partnering with a Michigan-based company, the Michigan State and the SBA to create $150 million focused only on job creation. I think there are very interesting events. I think the development, as I said, of the Shell gas initiative, a new industrial activity because of pipelines will change as well. I'm more positive.

I think market stability is increasing confidence. I think the most important fact -- and this is -- unfortunately, I'll end -- the opportunities are simply going to become too compelling. Anyone who would have read Warren Buffett's letters over the past couple of decades would have noted a real fear of technology. And waking up this morning or reading your Bloomberg or your Press last night to see an $11 billion investment -- his first or second biggest holding in IBM -- will tell you that sometimes things just become too compelling, and I think that’s what we'll find here in the United States. Thank you very much.

MR. BAILY: We're running right on, sort of, edge of our time, but if there are a couple of questions, maybe we'll feel them. Yes. Okay. But no speeches, please. Have we got a mic there? Is your question directed to one of the -- to Michael?

SPEAKER: Yes. (inaudible)) freelance correspondent, (inaudible). Thank you for your comment. And you are a financial market and you have several box and you say this is a continuum. I will suggest a change (inaudible) to the dynamic equivalent because this is -- (inaudible) between the two box.

And as to the capital; in this globalization stage, the capital can go anywhere. And there's lots of falling capital around the world, and the problem is this; how U.S. are going to capture it? U.S. is very hostile to foreign capital, and how to do about that? Thank you.

MR. BAILY: I guess the question is, is the U.S. hostile and what do we do about it if the U.S. is hostile?

MR. KLEIN: I think that there is -- as I indicated -- and I agree with you that the capital flows to where it's needed and wanted. And there are certainly economies that are focused directly on attracting that capital and using that capital for growth in their own nations. And whether that's concentrated FDI attraction program or it's just the elimination of policies that are restrictive in terms of the flow of people, and there is a significant question that is debated consistently about visa, the ability for those that are trained in this country, whether it's immigration policy or visa policy to stay and work or whether it's the flow of capital, vis-à-vis, CFIUS and others. These are complex issues, no doubt.

I think that they are issues that are front of mind to many in the business community and the investment community as real desires to both attract the people, the talent and the capital. And I think it is a fair statement and I think we do need to recognize private capital as just the tip of this iceberg that there is a competition for capital and resources. And countries today, whether they be developing or developed, are fighting for that access to that capital because, as we saw in just some of these statistics, if you take that capital out, you don't have growth. And I think your comments

are fair and spot-on. I think it's understood; complicated, but needs significantly more attention.

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