PRIVATE EQUITY HAS THE ABILITY TO OUTPERFORM TRADITIONAL ASSET CLASSES

Asset allocation has historically focused on traditional asset classes—equities, fixed income and cash instruments. However, institutional investors have shown an increased interest in alternative assets due to their potential to outperform the public markets. This objective has led institutions to invest in private equity, private debt, real estate and hedge funds in attempt to achieve return enhancement.

Private Equity, in particular, can offer:

- Ability to generate high rates of return over a long term horizon
- Managers who often have a high degree of control and influence over investments
- Legitimate access to non-public information prior to making an investment
- Strong alignment of interests between investors and management
- Expanded opportunity set of investments not typically available through the public markets

IN BRIEF

In an effort to enhance portfolio returns, many institutional investors are shifting portfolio allocations from traditional equity into private equity. Over the long term, private equity has the ability to outperform traditional asset classes.

- Public equities have generated long-term real risk-adjusted returns of between 6% and 7%. A well-implemented private equity portfolio may achieve a return of 4% to 5% in excess of that.
- Investors can gain access to private equity in a variety of investment vehicles. Commingled funds offer diversification by manager, strategy and geography, as well as potential access to sought-after private equity funds that are closed to new investors.
- Private equity funds may deploy a range of strategies in both corporate finance (buyouts, growth capital and restructuring) and venture capital (seed, early and growth stage).
- Investors should understand the importance of manager selection and how it correlates with return enhancement objectives.

FOR MORE INFORMATION

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such as growth through acquisitions or industry consolidation, management buy-outs and buy-ins, and refinancings and recapitalizations of recapitalizations of healthy or financially/operationally troubled companies.

• Venture Capital is the financing of start-up or emerging companies developing new business opportunities. Most venture capital investing has focused on new technologies in electronics, information technology, software, computers, telecommunications, materials, biotechnology, clean technology, and medical devices. There are also many service companies and consumer-oriented businesses that have been launched and developed with venture capital. Venture capital is an increasingly global business, however it remains largely concentrated in regions that are conducive to entrepreneurship and business creation.

The primary motivation for investing in private equity is return enhancement to the overall portfolio. EXHIBIT 1 illustrates that in the long term, private equity has outperformed traditional asset classes.

PRIVATE EQUITY STRATEGIES

Private equity strategies are often characterized according to the stage of company and how the company utilizes capital.

• Corporate Finance expects to emphasize investments in existing private companies that are expanding through growth strategies or fundamental business change. For example, investments may be made in businesses with growth trends that are seeking to expand through internal growth and generation of business efficiencies. These investments may be made to support business strategies such as growth through acquisitions or industry consolidation, management buy-outs and buy-ins, and refinancings and recapitalizations of recapitalizations of healthy or financially/operationally troubled companies.

<table>
<thead>
<tr>
<th>(%)</th>
<th>1 year</th>
<th>3 years</th>
<th>5 years</th>
<th>10 years</th>
<th>15 years</th>
<th>20 years</th>
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<td>Upper quartile</td>
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<td>21.1</td>
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<td>18.0</td>
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<td>All Private Equity</td>
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<td>12.0</td>
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<td>Lower quartile</td>
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<td>S&amp;P 500</td>
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<td>8.2</td>
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<td>Russell 2000 Growth</td>
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<td>9.2</td>
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<td>7.3</td>
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<td>15.0</td>
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Source: Barclays, Burgiss, FactSet, Hedge Fund Research, MSCI, NCREIF. Indices are unmanaged and shown for illustrative purposes only. Past performance is no guarantee of future results.

1 The private equity asset class results are sourced from the Burgiss Manager Universe and represent the pooled time-weighted returns that are net to investors, calculated using the Modified Dietz methodology.

2 HFR Composite reflects performance of HFRX Global Hedge Fund Index and HFRI Fund Weighted Composite Index.
addition, a commingled fund will conduct strict due diligence by evaluating teams, strategies, historical investments and the track record of individual private equity funds.

2. Strategy/Geography Diversification: Investment opportunities tend to be cyclical, with certain strategies and geographies performing better than others in different market environments. As a commingled fund diversifies across different management styles and strategies, it should be able to deliver performance through different cycles.

3. Increased fund access: Commingled funds offer an efficient and practical way of investing in a particular private equity segment while gaining exposure to a wide range of strategies and fund managers. Importantly, this can include those sought-after private equity funds that have already closed their doors to new investors because they have limited capacity. A well-established commingled fund manager can therefore provide access to high-quality private equity funds that might otherwise not be accessible to new entrants.

4. Reduced administrative burden: Developing and monitoring a private equity program is time consuming and resource intensive. Through a commingled fund structure, the manager is responsible for all facets of the accounting, legal, and other back-office processes of the commingled fund. Examples of the administrative burdens that a manager may handle for its investors include the following:

   • Correspondence with all underlying fund managers on all investment and administrative matters;
• Attendance at annual meetings for each underlying investment, as well as participation on advisory boards to ensure on-going due diligence and monitoring;
• Collection, review, and summarization of each underlying fund’s annual financial statement and tax information into a single Schedule K-1;
• Validation of items such as underlying partnership valuations and accounting treatment of distributions;
• Execution of all legal documents, including fund commitments, side letters, amendments, and consents; and
• Effective and efficient management of stock distributions

KEY CONSIDERATIONS OF PRIVATE EQUITY INVESTING

Private equity investing involves risks that are different to those present in traditional asset classes. Key considerations investors should undertake with regard to building a private equity program include:

Long-term time horizon

Private equity investment performance is dependent upon numerous exogenous factors including the business cycle, the receptivity of public debt and equity markets, and capital flows in the market. It is impossible to accurately “market time” private equity investments. The illiquidity and contractual obligations of commitments limit the ability to tactically enter and exit the market. A disciplined long-term approach of committing to attractive investment opportunities each year, over typically a three-year period, is the optimal strategy to mitigate the volatility of the investment cycle.

Illiquid asset

Unlike many other alternative investments, private equity investments generally do not have investor-driven reinvestment or redemption features. An investor determines their commitment amount to the private equity investment and that capital will be invested, or “called”, as and when it is needed for investments or the payment of fees and expenses. Typically the committed capital is called over a 4+ year period. Capital is returned, or “distributed,” to investors as investments provide liquidity or are exited from the portfolio, generally through sales or public market events. Typical annual cash flows of a single private equity fund are illustrated in EXHIBIT 4. Further, many private equity investors are limited or restricted in their ability to sell a private equity investment.

J-curve effect

A private equity investor needs to be comfortable with the phenomenon of the J-curve in private equity investments. The J-curve effect represents the pattern of returns realized by plotting the returns generated by a private equity fund against time (from inception to termination). Payment of fees and start-up costs in the early years of a partnership, prior to any returns to the investor, causes capital contributed to be higher than the book value of the portfolio investments. As a result, a private equity fund will typically show a negative return in its early years. Another impact on early returns is the writing down of portfolio investments that, under a sponsor’s investment program, are considered to be behind plan. Investment gains usually come in the later years as the portfolio companies mature and increase in value. When the first realizations are made, the fund returns may rise quite steeply and can offset remaining capital calls for investments and expenses.
Execution

Implementation through investment selection is the most crucial element in achieving return enhancement. As illustrated in EXHIBIT 5, the dispersion of returns (top through bottom quartile) among private equity investments is significant in absolute terms and substantial relative to other segments of the investment universe. The average dispersion of returns among funds in the Burgiss PrivatiQ Universe is over 1,800 basis points. Due to this dispersion, portfolio implementation is as important (or more important) than the asset allocation decision of how much to allocate to alternative investments. It is our view that the requisite return enhancement objective will not be achieved consistently by matching average or median industry-relative performance. Private equity investment strategy must be formulated with the goal of consistently delivering industry-leading (e.g., top-quartile) relative performance.

Due diligence and manager selection

Achieving top quartile performance is not random but rather correlated with a partnership’s level of access to investment opportunities, strength of relationships with entrepreneurs and management teams, ability to capture the best business plans and tap strategic investors, and first-hand operating experience in building and strengthening businesses, to name a few factors. In order to meet the objective of return enhancement, it is critical that a private equity investor “invest with the best” on a consistent basis by partnering with a team that has long standing relationships with the best partnerships, a due diligence process to identify “up and coming” top performing partnerships, and a selective and disciplined nature to ferret out those groups that are not able to maintain their premier performance.

The importance of an in-depth due diligence process cannot be overstated. It can serve as an extremely effective mechanism to strengthen partnerships with the most talented manager, thereby fostering a deeper understanding of transparency and dialogue, and sometimes a first call when capacity becomes available. Some of the key items to understand/ review in the due diligence process are (please note that this list is not comprehensive):

1. Background of firm and partners
2. Status of general partner
3. Deal flow
4. Performance track record
5. Investment strategy
6. Terms of proposed fund

CONCLUSION

As capital continues to be committed to private equity in substantial amounts, it is important for investors to understand both the benefits and the risks of investing in private equity. Private equity investments have the potential to provide return enhancement to an investor’s portfolio. However, this return enhancement comes at the price of a long-term time horizon, illiquidity, J-curve effect and execution risk.

A private equity commingled fund manager may have the ability to opportunistically construct and manage a private equity portfolio that will meet an investor’s needs through manager, strategy and geographic diversification. Such a manager may also have access to select oversubscribed investment opportunities that an investor may be unable to invest in directly. When evaluating a private equity commingled funds manager, it is important to consider the history and experience of the team, as well as the manager’s track record and longevity, as that will give some indication of the ability to manage through different investment cycles. One should also evaluate the depth and quality of a manager’s resources, as those resources will be necessary to conduct proper due diligence. Such due diligence is an important aspect of manager selection, which is a crucial element in the successful implementation of a private equity program.
INVESTMENT INSIGHTS

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