WHY INVEST IN PRIVATE EQUITY? THE PRINCIPAL OBJECTIVE IS TO ENHANCE RETURNS OF DIVERSIFIED PORTFOLIOS.

Asset allocation has historically focused on traditional asset classes—equities, fixed income and cash instruments. Investors, however, are increasingly interested in the potential of alternative assets (private equity, private debt, real estate and hedge funds) to improve portfolio performance over the long term, especially given the outlook for continued modest traditional market returns.

These alternative investments have different roles to play in a portfolio, from enhancing return to diversifying risk to increasing income. In the case of private equity, the primary motivation for investing is clearly potential return enhancement. Over the long term (10 years or more) private equity has outperformed traditional public equity markets (EXHIBIT 1, next page). Given the generally high correlation between these markets, shifting from public to private equity is more likely to enhance returns than improve diversification.

Often, investors target excess returns in the neighborhood of 3% to 5% for their private equity allocations. Realizing the potential return advantage of private equity requires a knowledge of what PE consists of, its investment characteristics and the essential aspects of successful execution—each discussed here.
In the long term, private equity has outperformed world and U.S. public equity.

**Types of Private Equity Opportunities**

Different strategies can provide diversified sources of PE returns.

**Corporate finance:** Investing in existing companies

- Common strategies include: expansion/growth, buyouts, restrukturings, add-ons, consolidations, distressed/turnarounds.

**Venture capital:** Investing in start-up companies

- Common strategies include: seed, early stage, expansion/growth.

Qualified institutions and high net worth individuals typically invest in private equity through fund structures. These generally take the form of limited partnerships managed by general partners (GPs) who raise capital from investors, invest alongside these limited partners (LPs), identify and select portfolio company investments and generally have a significant level of engagement in the management of these companies. Less frequently, investors gain exposure to private equity by investing directly in operating companies. Additionally, investors can access the secondary market for PE, through which a limited partnership or company interest is transferred from the seller to the buyer. This market has developed and matured over time, and though interests are generally purchased at a discount, the market can be cyclical and the quality of available assets is mixed.

While institutions with scale and relationships can access private equity funds and companies directly, many investors gain exposure to private equity with the help of investment consultants or through professionally managed separate accounts or commingled vehicles.
CHARACTERISTICS OF PRIVATE EQUITY INVESTMENTS

The very nature of private equity investing, whether corporate finance or venture capital related, defines its investment characteristics—in terms of both risk and potential rewards. Investors should assess their risk appetite, cash flow needs and return requirements, and be sure that they understand and are comfortable with these fundamental characteristics of PE:

A long-term horizon with unique cash flow patterns—The total life of fund investments typically extends over a period of 10 to 12 years from capital commitment to final distributions (EXHIBIT 2). Committed capital is not used immediately, as with typical investments made in the public markets. Rather, cash must be available for investment as portfolio companies are identified and their growth strategies implemented. The distributions vary in timing and magnitude, and occur over the life of the investment.

Illiquidity—Commitments are generally for the long haul. Unlike many other alternative investments, private equity investments typically do not have reinvestment or redemption features. Further, for many investors, the ability to sell a private equity investment can be limited by their investment agreements. Even if investors are able to sell positions in the secondary market, as described above, interests generally trade at a discount and the market itself can be cyclical, further impacting prices.

The J-curve effect—The J-curve represents the pattern of returns an investor can expect to realize from a private equity fund over time, from inception to termination. A private equity fund will often show a negative return in its early years, when fees and start-up costs are incurred and investments considered to be behind plan are written down—all prior to any returns to the investor. Investment gains will usually come in the later years as portfolio companies mature, increase in value and are ultimately exited with returns realized.

Attractive return potential—The above characteristics define some key differences between private equity investing and public equity investing. They also explain why private equity investors anticipate a higher level of compensation for investing in private vs. public equity opportunities—an expectation that private equity investing has met over the long term. This potential return advantage, like the characteristics above, is rooted in the definition and nature of private equity:

• an expanded opportunity set of investments not typically available through public markets
• legitimate access to non-public information prior to making an investment
• a strong alignment of interests among GPs, LPs and company management
• a high degree of control and influence over investments

Those investors who are able to make these long-term commitments to relatively illiquid private equity investments have the potential to experience rewarding returns over time.

EXECUTION—REALIZING THE PRIVATE EQUITY OPPORTUNITY

Successful private equity investing requires skillful execution. That means starting with a diversified private equity portfolio allocation strategy, implemented through a disciplined private equity investment program that incorporates top-performing funds and investments.

A diversified private equity portfolio strategy

Constructing a diversified private equity portfolio designed to meet an investor’s return and risk objectives requires knowledge of and access to a broad array of private equity investment opportunities—across strategies, geographies, industries and vintage years—available through funds or direct investments, in the primary and secondary markets.

Source: J.P. Morgan Asset Management, Private Equity Group.
A disciplined investment program

A systematic and consistent approach to private equity—namely, committing to attractive investment opportunities each year—is the optimal strategy for most private equity investors. 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 into the private equity market, making it impossible to accurately “market time” private equity investments. What’s more, illiquidity and contractual obligations of commitments limit the ability to tactically enter and exit the market. A disciplined, multi-year approach can help to mitigate the volatility of the investment cycle.

Due diligence and investment selection

Implementation through discerning investment selection is the most crucial element for achieving return enhancement through private equity. The dispersion of returns among private equity investments is substantial in absolute terms and relative to other segments of the investment universe. For example, as illustrated in Exhibit 3, the average dispersion of returns from top to bottom quartile among private equity funds is over 1,900 basis points (bps). Due to this dispersion, portfolio implementation is as important (or more important) than the decision of how much to allocate to private equity. It is our view that the return enhancement objective will not be achieved by merely matching average or median industry performance. A private equity investment strategy must be formulated with the goal of consistently delivering industry-leading (e.g., top-quartile) performance.

In the quest for top-quartile private equity returns, relationships and sources of deal flow are more critical than in the public markets since there is no perfect source of information about private companies and private equity opportunities.

Furthermore, the importance of an in-depth due diligence process cannot be overstated. 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. Unless the requisite skills and resources are available in-house, this means joining forces with a manager and/or consultant that has long-standing relationships with top-performing GPs, a due diligence process to identify “up and coming” high conviction partnerships, and a selective and disciplined nature to ferret out those groups that may not be able to maintain their premier performance. A strong due diligence process can serve as an extremely effective mechanism to strengthen relationships with the most talented GPs, thereby fostering deeper understanding, transparency and dialogue—and sometimes a first call when return-enhancing opportunities to invest directly in companies and/or obtain private equity interests through the secondary market become available.

Some of the key items to understand and review in the partnership due diligence process are:

- background of the firm and partners
- status of the general partner
- investment strategy
- deal flow
- company-level due diligence capabilities
- performance track record
- terms of the proposed fund

At any point in time, investing with top-performing partnerships engaged in fundraising is essential but may not be sufficient to ensure access to the most attractive private equity opportunities. Direct company and secondary market investments can expand the opportunity set. Working with a manager or consultant able to apply partnership- and company-level due diligence skills across strategies and geographies can help in the evaluation of both individual company investments and the embedded portfolios of

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Exhibit 3: Dispersion Between Top- and Bottom-Quartile Private Equity Funds

<table>
<thead>
<tr>
<th></th>
<th>First quartile</th>
<th>Pooled</th>
<th>Median</th>
<th>Third quartile</th>
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</thead>
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<tr>
<td>5 years</td>
<td>19.3</td>
<td>14.1</td>
<td>9.1</td>
<td>18.2</td>
</tr>
<tr>
<td>10 years</td>
<td>8.6</td>
<td>6.8</td>
<td>8.8</td>
<td>12.5</td>
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<tr>
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<td>-1.3</td>
<td>-2.5</td>
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<tr>
<td>20 years</td>
<td>-3.7</td>
<td>-1.5</td>
<td>-1.3</td>
<td>-2.5</td>
</tr>
</tbody>
</table>

Source: Burgiss; data as of September 30, 2017.

The dispersion results are sourced from the Burgiss Manager Universe and are based on the individual internal rates of return (IRRs) as of September 30, 2017, for all private equity funds.
companies in partnership interests available in the secondary market. These skills include analysis of a company’s:

- market
- operations
- labor resources
- facilities, equipment and asset base
- customers
- capital structure and sources/uses of proceeds

COMMINGLED FUNDS: BENEFITS OF A MULTI-STRATEGY BLEND

Private equity commingled funds have proven to be a popular way for investors to access the private equity universe, particularly when the requisite skills and resources are not available in-house. A private equity commingled vehicle is a portfolio of private equity funds structured to provide diversified exposure to private equity across managers, investment strategies, industries and geographies, and may also invest in secondary and direct investments (EXHIBIT 4). A commingled fund simplifies the process of choosing among separate private equity funds and blends different funds and investments to achieve a specific risk-return objective while providing greater diversification than a single manager.

Commingled funds provide a simplified approach to constructing a diversified portfolio of high quality PE funds and investments

EXHIBIT 4: THE COMMINGLED FUNDS OPTION

When properly constructed, a commingled fund seeks to deliver attractive risk-adjusted returns and a more consistent return stream than an individual fund through:

Manager diversification—A commingled fund can mitigate manager risk by more broadly diversifying its assets across multiple managers instead of investing all assets with a single GP or a small number of GPs. In addition, a commingled fund will conduct strict partnership due diligence by evaluating teams, strategies, historical investments and the track records of individual private equity funds.

Diversification among strategies and geographies—Investment opportunities tend to be cyclical, with certain strategies and geographies performing better than others in different market environments. A commingled fund that diversifies among management styles and strategies should have the potential to deliver performance across the various stages of a market cycle.

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 due to limited capacity. A well-established commingled fund manager can therefore provide access to high quality private equity funds that might otherwise be inaccessible to new entrants.

Direct and secondary investment—Commingled funds may be able to improve performance by gaining access to direct investment opportunities not available to all investors. They can also seek opportunities in the secondary markets, thereby gaining exposure to investments in the later stages of the investment cycle, when cash flows are more likely to be positive, potentially tempering the J-curve effect.

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

- correspondence with all underlying fund managers on all investment and administrative matters
- ongoing due diligence throughout the life cycles of
investments—facilitated, for example, by attending annual meetings and participating on advisory boards
• collection, review and summarization of each underlying investment’s annual financial statement and tax information in a single Schedule K-1
• validation of items such as underlying investment valuations and accounting treatment of distributions
• execution of all legal documents, including commitments, side letters, amendments and consents
• effective and efficient management of stock distributions

CONCLUSION
Private equity has the potential to provide returns in excess of public market equities. Investors should determine what PE investments are appropriate for their portfolios, based on risk appetite, return objectives and liquidity requirements. PE markets are difficult to time; a PE portfolio, constructed through a consistent, multi-year investment program and diversified across managers, styles and geographies is critical. Investors—unless they have a well-developed PE industry network, in-depth knowledge of PE markets and a discriminating due diligence process—should aim to partner with a consultant, separate account or commingled fund manager that is well resourced and proven. This can significantly aid in the construction and management of a PE portfolio of top-performing funds and investment opportunities, structured to provide attractive risk-adjusted returns over the long term, in line with the investor’s needs and objectives.