



## OVERVIEW

This primer describes the asset class commonly known as Private Equity. It attempts to answer the types of questions Trustees would be likely to ask when considering an investment in this area.

Historically, private equity investments have often been grouped in a larger category of investments called Alternative Investments. Alternative Investments were defined to be any investments other than publicly traded stocks and bonds. In addition to private equity investments, alternatives often included real estate, hedge funds, portfolio insurance schemes, trading and arbitrage programs, long/short portfolios, and various derivative-based programs.

This primer is limited to private equity investments, which Meketa Investment Group defines to be investments in companies that are privately owned. Further, this primer only describes the characteristics of the asset class itself. It does not suggest a target allocation to the asset class, nor does it specify how to implement an investment program in private equities. These issues are client specific, and must be addressed by the decision-makers in each group.

## WHAT IS PRIVATE EQUITY?

Private equity investments are simply investments in privately held companies. Private equity investments are generally structured in the form of partnerships that consist of ten to twenty equity investments in individual companies.

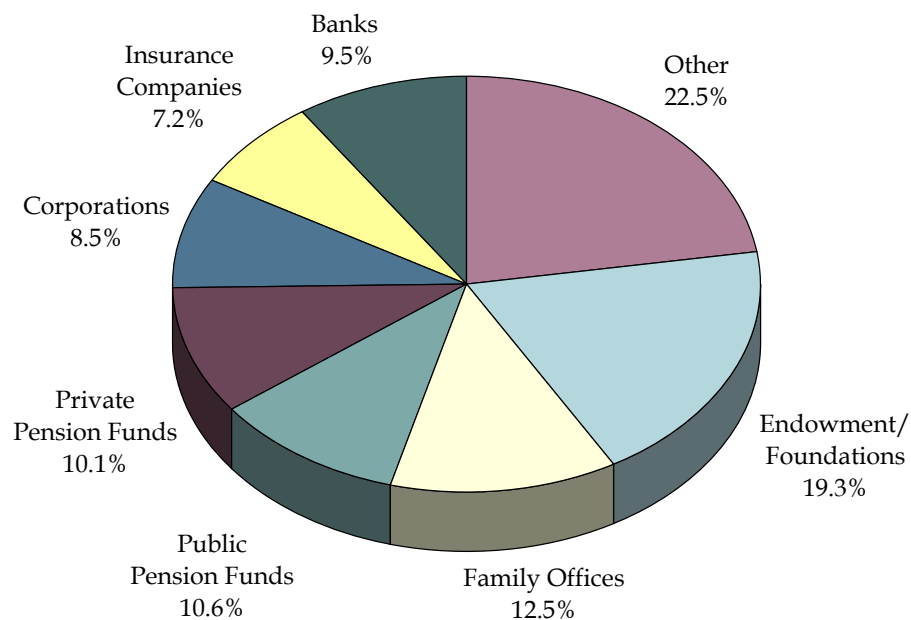
Like investments in publicly traded common stocks, investments in private equity funds provide long-term investors with stakes in generative assets (i.e., equity positions). However, unlike publicly traded stocks, private equity funds are not priced daily by a market. Thus, the apparent price volatility is lower and the interim return correlation to public equities is subdued.

It is widely believed that the market value of privately held companies is comparable to that of publicly traded company shares. However, there are many more private companies than public ones. Historical studies have shown that the ratio of U.S. private companies to public companies is 100:1. Thus, the private equity market provides a large arena for investing.

Today, private equity investments come in many forms, including venture capital funds, buyout/LBO funds, mezzanine debt funds, and international private equity funds. All of these strategies produce significantly different returns than traditional investment classes, and exhibit different fundamental characteristics from each other.

**WHO INVESTS IN PRIVATE EQUITY?**

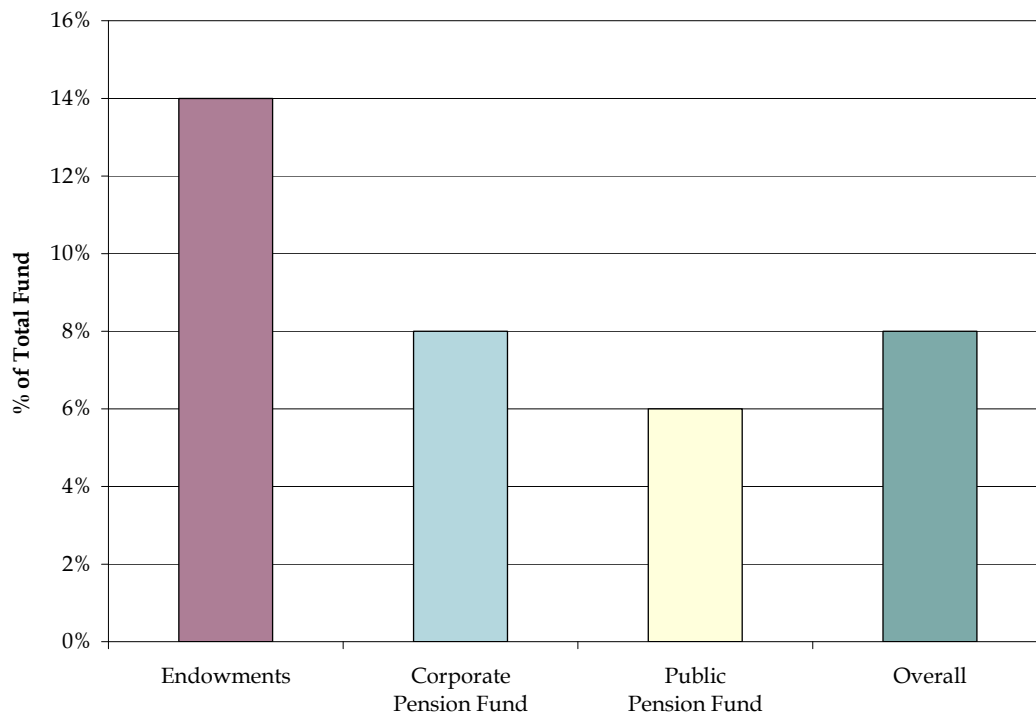
- Pension funds, endowments, foundations, high-net-worth individuals, and other types of investors.
- Investors seeking higher returns and enhanced equity diversification, beyond that available through the public stock market
- Long-term investors who are willing to invest some portion of their portfolio in illiquid assets
- Investors willing to accept greater or different risks

**Private Equity Commitments****1999-2009**

Source: *VentureXpert*, August 2010

**HOW LARGE IS A TYPICAL INVESTMENT IN PRIVATE EQUITY?**

- According to a survey conducted in 2007 by Goldman Sachs and Russell, the average U.S. pension fund investing in alternative assets has set a target allocation of 8% for private equity.

**Private Equity Allocation by Investor Type**

Source: Goldman Sachs/Frank Russell, 2007 Report on Alternative Investing

## WHY INVEST IN PRIVATE EQUITY?

- Increase investment returns by “selling” unneeded liquidity to capital-needy businesses.
- Take advantage of the larger mispricing opportunities.
- Improve the value of the asset by being a “control” investor.
- Better alignment of interests between the owners and management.
- Private owners generally produce better financial results.
- Experience greater potential for (more persistent) alpha.



Source: VentureXpert, August 2010

### WHAT RETURNS CAN INVESTORS EXPECT?

Historically, private equity investors have tended to earn 2% to 5% per year more than comparable common stock investors, even after paying substantial management fees and carrying costs. Academics and practitioners have offered a number of explanations for this superior performance.

- Private investments are held in the form of relatively illiquid partnerships. Generally, investors demand a premium for liquidity risk; that is, they expect to earn a higher cumulative return as compensation for giving up liquidity on a short-term basis.
- Private company managers often have a strong personal motivation to achieve success: they own a part of the company themselves. In private companies, the percentage of ownership in the hands of the operators is much higher than for public companies.
- Private equity companies have more freedom to make value-creating decisions. Because the owners of private companies are accountable only to their other partners, there is no need to satisfy analysts' demands for short-term performance. The owners are free to make business decisions to enhance long-term shareholder value without fear that their stock price will be battered by short-term market expectations.
- Private equity investors focus on growth, not the creation of stable value. At every level, from startup venture capital to mature industry buyouts, the goal is to create new wealth through growth.

Different sectors of the private equity market have produced different returns, as shown in the table below. In addition, the inter-quartile spread of private equity managers compares favorably to that of large cap managers, suggesting private equity managers have significantly more opportunity to add value.

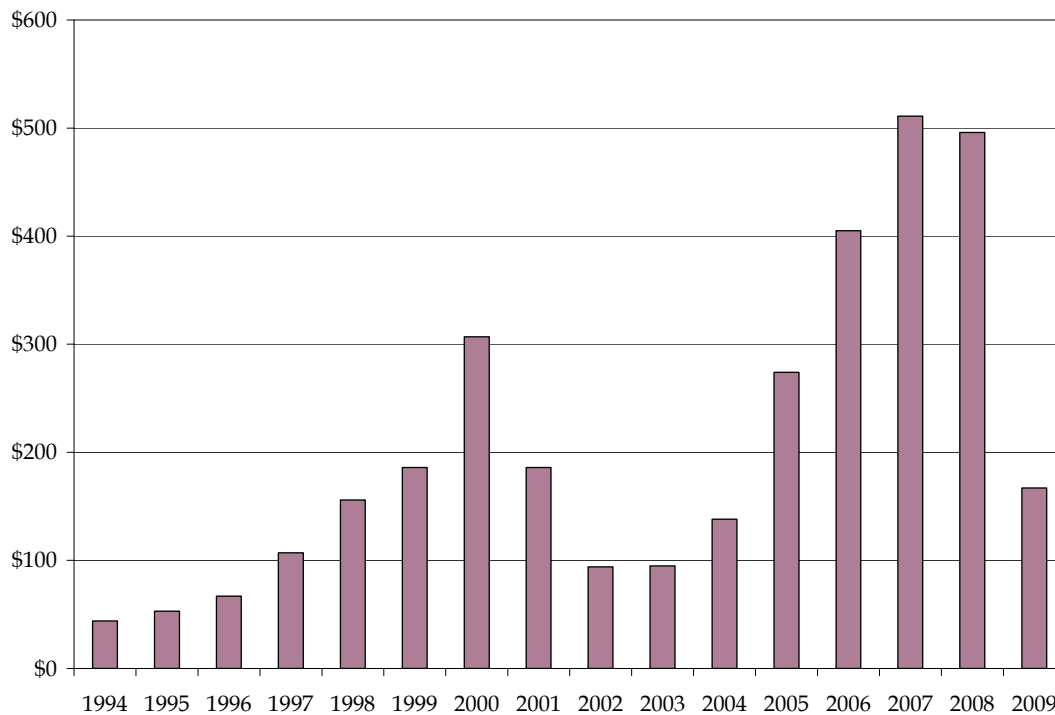
July 1986 - June 2010	Venture Capital	Buyouts	Mezzanine Debt	Russell 3000
Annual Return	13.6%	9.4%	10.2%	8.5%
Annual Std. Dev.	20.3%	16.7%	8.8%	16.0%
Maximum Yearly Loss	-41.6%	-53.8%	-14.7%	-43.5%

Last 10 Years	Venture Capital	Buyouts	Mezzanine Debt	U.S. Stocks
Inter-quartile Spread	14.1%	18.8%	5.7%	3.1%
Value added at 25 <sup>th</sup>	8.7%	11.1%	2.6%	2.3%

Source: *VentureXpert, eVestment Alliance. Data for PE funds raised from 2000 through 2009 and U.S. equity managers for the trailing ten years as of mid-2010.*

**WHY INVEST IN PRIVATE EQUITY NOW?**

- The private equity marketplace has become increasingly developed and sophisticated, attracting institutional investors of all types.
- The private equity marketplace has reached a size at which it should not be ignored by institutional investors of sufficient size.
- Fundraising and deal activity peaked in 2007. Prices subsequently declined to pre-2005 levels. This has driven the industry “back to basics”: raising smaller funds, doing smaller deals, using less debt, and expecting longer hold periods.

**Annual Commitments to Private Equity (\$ billions)**

Source: VentureXpert, August 2010

### HOW DO PRIVATE EQUITY PARTNERSHIPS WORK?

Most of the private equity partnerships created for sale to institutions, such as pension funds and endowments, take the following form. First, a general partner creates the legal framework of the partnership, prepares an Offering Memorandum, and raises commitments from institutional investors, who become the limited partners. Each partnership agreement specifies a legal “lifetime,” usually ten years, by the end of which all of the investments must be liquidated and the proceeds returned to the investors.

The Offering Memorandum describes the types of investments the general partner intends to make, but does not specify the actual investments, since they have not yet been made. As a result of this uncertainty, such a partnership is known as a “blind pool.” Most private equity partnerships begin as blind pools.

When enough capital has been subscribed (committed but not yet invested), the general partner “closes” the partnership and begins making specific investments. Over the course of several years, the general partner may purchase stakes in ten to twenty different underlying firms. Thus, each partnership is actually a collection, or portfolio, of individual company investments, not a single investment.

At the beginning, the investments are generally carried (priced) at cost, and the limited partner investors experience a small negative return, calculated as their initial investment minus the associated startup expenses.

By the middle of the partnership period, some early investments may already have matured, been sold, taken public through an IPO, or otherwise liquidated. The proceeds from these liquidations are generally *not* reinvested in the other investments, but are repatriated immediately to the limited partners, as specified in the terms of the partnership agreement. As the end of the partnership period approaches, most of the underlying assets will have been sold. Thus, all private equity partnerships are self-liquidating, generally over a period of about eight to twelve years.

Note that private equity partnerships are not SEC registered, and that the general partner does not generally accept the role of fiduciary as defined by ERISA. However, many plan sponsors use an investment advisor who does serve as a fiduciary to select these partnerships.

### COMMITTED VERSUS INVESTED CAPITAL

Private equity partnerships require an advance commitment of capital. The majority of the commitment is drawn down (“called”) by the general partner over a period of usually three to five years, during which time the actual investment is *less* than the committed amount. Normally, the general partner will hold a portion of the commitment for the future financing of the portfolio companies acquired during the investment period. Also, while one commitment is being drawn down, other partnerships may be paying off, effectively removing investments from the asset class.

Therefore, to maintain a fixed level of *actual* investment in the private equity asset class, it is necessary to make a greater commitment than the target allocation. One rule of thumb says that in order to have \$1 actually working in private equities, an investor must be prepared to commit \$1.50 to \$2.00.

### WHAT ARE VINTAGE YEARS?

To remain prudently invested, both public and private equity portfolios must be diversified across many different individual investments. In both cases, this means investments in companies of different sizes, situated in different geographic areas, and involved in different business activities.

However, unlike public equity portfolios, private equity investments should be diversified across time as well. Since individual partnerships have finite life spans, new partnerships are created every year. The year in which a partnership closes to new investors is known as its “vintage year.” Depending upon macro-economic events, some vintage years have better performance than others. Therefore, it is essential to structure investments and plan cash flows to ensure diversification across multiple vintage years.

### WHAT ABOUT SHORT-TERM LIQUIDITY?

Although they are self-liquidating, usually over periods of eight to twelve years, private equity partnership interests are not traded on a short-term basis. Until the early 1990s, there was virtually no secondary market through which an investor could sell a partnership interest prior to final maturity. This lack of short-term liquidity was a deterrent to some investors, and perhaps limited the growth of the asset class.

Most private equity investors have limited need for short-term liquidity. However, there are many factors helping to create a secondary market for private equity partnerships. For example, when a public company is acquired by another company, its existing pension fund assets may be merged into those of the new parent. If the acquired company's pension fund holds private equity partnerships, these may not fit into the structure of the parent pension fund.

Over the past decade, there has been a growing secondary market for private equity partnerships. This secondary market creates liquidity for existing investors, but it also comes at a price, as most buyers of partnership interests will expect to purchase the assets at a discount to their NAV.

The secondary market also offers new investors in private equity the opportunity to "buy into" seasoned, existing funds, thus accelerating an otherwise lengthy startup period.

### HOW DOES A FUND INVEST PRUDENTLY IN PRIVATE EQUITY?

A fund's investment in private equity should be structured similarly to its investment in public equity. Private equities simply represent another equity asset class, another component of a fund's long-term strategic investment plan.

Private equities should be selected by professionals, and carefully structured and monitored. Working closely with their private equity manager(s), Trustees should take the following steps:

- Specify in advance their fund's long-term allocation to private equity investments.
- Develop an investment policy and set of investment guidelines, including targets for performance and diversification (e.g., by geography and partnership type).
- Conduct a cash flow analysis to plan how the target allocation will be achieved and maintained.
- Construct a portfolio of individual private equity investments that is consistent with these objectives.
- Scrutinize each investment closely, to identify its unique characteristics and risks. Note that the analysis, due diligence, and legal review of these partnerships are significantly more complex and comprehensive than that entailed in public security manager searches.
- Monitor all private equity investments, to ensure that fund assets are invested prudently and as intended.
- Control the private equity allocation by reinvesting distributions into additional future private equity partnerships.

Note that these steps are quite similar to those for other asset classes.

### HOW DOES A FUND STAY INVESTED?

Unlike public common stock investments, private equity partnerships are self-liquidating. Thus, if assets are committed to private equity in a single partnership, and if the lifetime of that partnership is ten years, then a fund will be liquidated back out of private equities within ten years.

While the maximum length of each partnership's life span is known in advance, the actual pattern of interim cash flows cannot be predicted. If a partnership's early investments are particularly favorable, leading to early dispositions, then much of the original commitment may be returned to the limited partners almost immediately, making it impossible to achieve a fully invested target allocation.

The experience of many institutional investors has demonstrated that an intensive, on-going reinvestment program is necessary with private equities to maintain any specified target allocation. In other words, the private equity investor must constantly seek new partnerships to reinvest the liquidation proceeds of maturing partnerships. This process is complicated by the unpredictable timing of both liquidations and new capital calls.

### WHAT IS A FUND OF FUNDS?

To achieve adequate diversification, investors have two options. First, as described above, they can purchase positions in a variety of partnerships, diversifying across vintage years, and selecting partnerships investing in different areas and using different general partners. This approach minimizes costs and allows the investor to create a customized pool of partnerships. The main disadvantage of this method is administrative: selecting and overseeing many different partnerships is an on-going, complicated process. A second solution is to hire a "fund of funds" manager. A fund of funds is what its name implies: a collection of many partnership funds managed by a master partner.

A fund of funds is structured as a partnership. The manager of a fund of funds is the general partner and may or may not be an investment manager as defined by ERISA. The manager selects the underlying funds, and provides administrative accounting.

Funds of funds are designed to appeal to a broad spectrum of potential investors, but particularly those without the resources to select and monitor funds themselves. A typical fund of funds is designed to provide exposure to many different sectors, in proportions that the manager believes are prudent. As a consequence, it is not possible for participants to control individual investments. For example, when using a fund of funds approach, an investor usually cannot favor buyout funds while limiting venture capital exposure.

Just as with direct private equity funds, a fund of funds is organized as a blind pool. That is, when a new fund of funds is announced, and a subscription target is set, early investors do not know what specific funds will be selected by the manager. Generally, the Offering Memorandum gives the manager almost unlimited latitude in making subsequent investments.

The significant advantages of a fund of funds are potential access to top performing funds, diversification, and administrative ease. The top performing private equity funds are in the market raising capital for relatively short period of time and are often oversubscribed. The general partner, in that situation, has the right to select the limited partners. A fund of funds manager may have relationships with these groups and, as such, may have easier access to them. A fund of funds may invest in fifteen or more underlying funds, each of which may consist of ten or more investments. When fully invested, a fund of funds may therefore consist of several hundred different investments. Also, individual funds may be selected from several vintage years, and thus there is some diversification across time, as well.

This added diversification comes at a significant cost. Fund of funds managers typically charge a management fee of 1% more per year, which is added to even higher fees charged by each of the individual funds. Also, the manager of the fund of funds often takes a share of the profits (carried interest) that remain after each of the underlying funds deduct their share of the profits.

Funds of funds can be very large, with most ranging in size from \$250 million to several billion dollars. Fund of funds managers contend that this size gives them direct access to the very best deals, from which smaller funds would be excluded.

Because a fund of funds is a partnership, it has a finite lifetime and is self-liquidating. When a fund of funds is started, its year of closing becomes its vintage year. While the manager may take several years to invest in underlying funds, thus investing across calendar years and vintage years at the underlying fund level, once the fund of funds is fully invested, it is effectively "frozen," and begins to self-liquidate. *Thus, a fund of funds does not eliminate the need to search for new funds in order to stay fully invested in the asset class.*

### HOW ARE COSTS AND FEES STRUCTURED?

Private equity investment programs are much more complicated to create and administer than public equity programs. Private equities involve long-term planning, adjusting to liquidity constraints, complicated accounting procedures, and extensive legal review.

There are two generic types of fees associated with private equity investing. The first is a fee for professional portfolio management. This fee is generally higher than the fees charged by stock and bond managers, typically ranging from 1.5% to 2.5% per year.

The second type of fee is called “carried interest,” and it represents a type of performance incentive fee for the general partner. With carried interest, once the general partner has produced a minimal baseline return for the limited partners (called a “hurdle rate”), all future profits are divided between the general partner and the limited partners. For example, a partnership may specify a hurdle rate return of 8% and a carried interest of 20%. This means that as soon as the limited partners have received a return of 8% on their initial investment, all future profits are distributed 20% to the general partner, and 80% to the limited partners.

Using a fund of funds introduces another level of management fees on top of those incurred at the partnership level, generally ranging from 0.5% to 1.5% per year.

All of the costs and fees associated with private equity investing are higher than for public market securities. Any investor in private equities must consider these costs carefully. Fortunately, the higher fees can be offset by the higher potential returns.

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### HOW IS PRIVATE EQUITY DIFFERENT ADMINISTRATIVELY?

The administration of private equity investments differs substantially from that of public market investments in three important areas: maintaining target allocations, management of cash flows, and performance reporting.

Because of their illiquid nature, private equity investments cannot be bought or sold easily. As a result, unlike public market investments, an allocation to private equity investments cannot be finely tuned regularly with periodic rebalancings. The potential therefore exists for regular deviations from a Fund's private equity target allocation due to capital flows, performance differentials across asset classes, and the constantly changing ratio of committed to invested private equity capital.

The cash flows associated with private equity investments are frequent and unpredictable. Generally, there is little advanced notice of capital calls, distributions of cash proceeds, or the receipt of securities in-kind. Fund administrators must have procedures in place to accommodate these cash flows reliably and efficiently.

And finally, no regular market valuation mechanism exists for private equity investments. Consequently, short-term performance measurement provides little information. Typically, private equity investments exhibit modest changes in value until a formal transaction (i.e., additional financing or a disposition) results in the realization of a gain or loss on the investment. In addition, valuations from the general partner or from the fund of funds manager are typically available well after the valuations for public market portfolios. For example, December 31 valuations are usually not available until the second quarter of the following year. Once private equity investments are sold, usually over a period of five or more years, then performance evaluation becomes more meaningful.

### CONCLUSIONS

Private equity investing is compelling for several reasons. First, investors should receive a premium for sacrificing liquidity. Second, private equity is an inefficient asset class with more opportunities to identify mispricings. Third, control of an asset allows for operational and governance improvement, leading to added value. Fourth, private equity managers have unique expertise and the ability to generate persistent alpha.

While the case for investing is compelling, plan sponsors should be aware of the unique aspects of a private equity investment. Private equity differs from many more familiar investment vehicles in terms of the timing of payments, costs, liquidity, and areas for diversification. As always, Meketa Investment Group recommends that plan sponsors conduct careful due diligence to make sure that any investment matches the fund's objectives and constraints.