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 usually 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 aggregate 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 from traditional investment classes, and exhibit different fundamental characteristics from each other.

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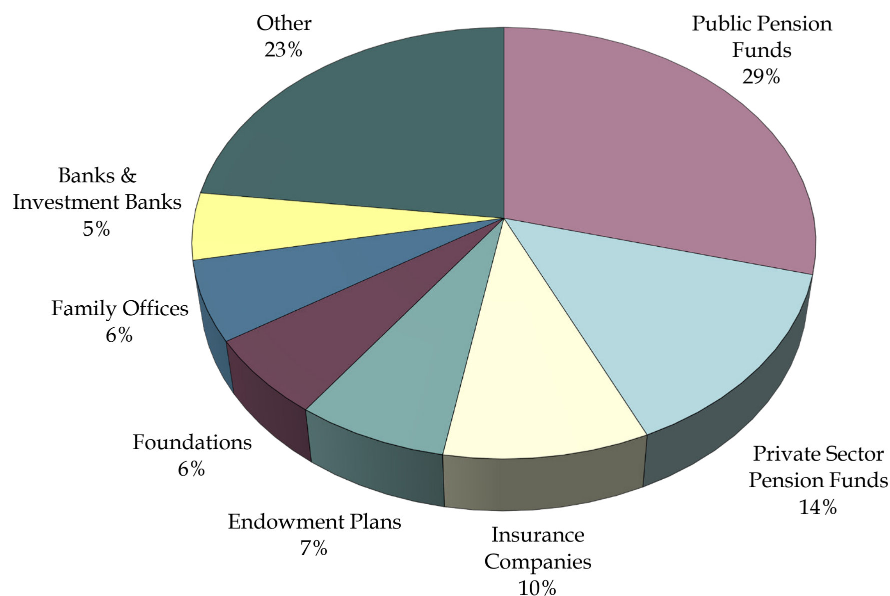
WHO INVESTS IN PRIVATE EQUITY?

- Pension funds, endowments, foundations, high-net-worth individuals, and other types of long-term 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.

Amount of Capital Invested in Private Equity by Investor Type

As of 6/30/14



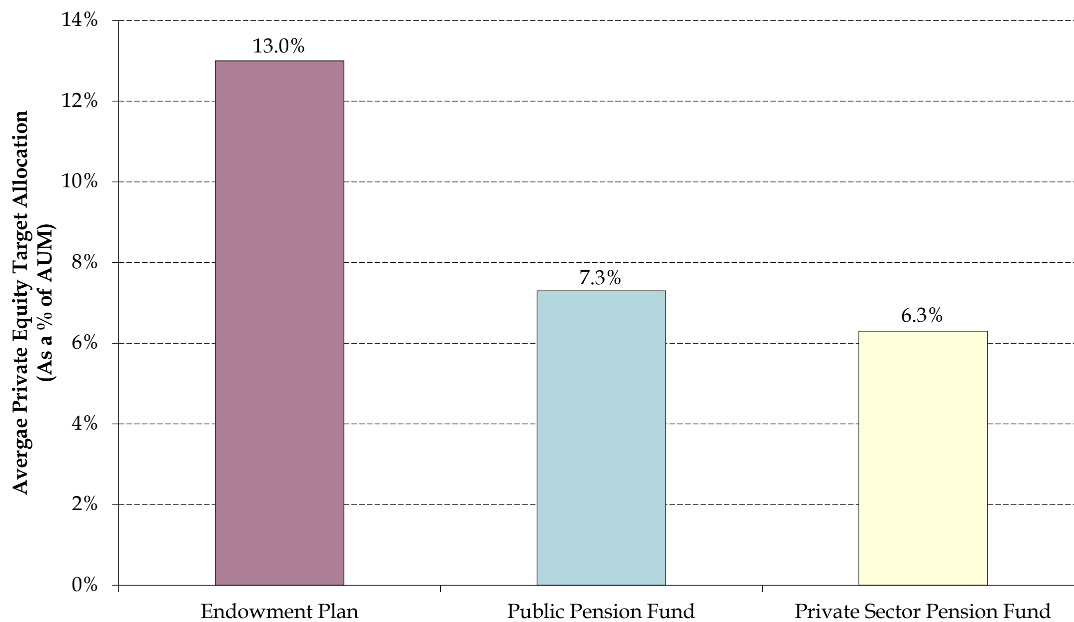
Source: Preqin

HOW LARGE IS A TYPICAL INVESTMENT IN PRIVATE EQUITY?

- The average institution investing in alternative assets has set a target allocation of 6% to 13% for Private Equity.
- This represents the target for the entire Private Equity program, not for an individual investment.

Average Private Equity Target Allocation by Investor Type in 2014

(As a % of AUM)

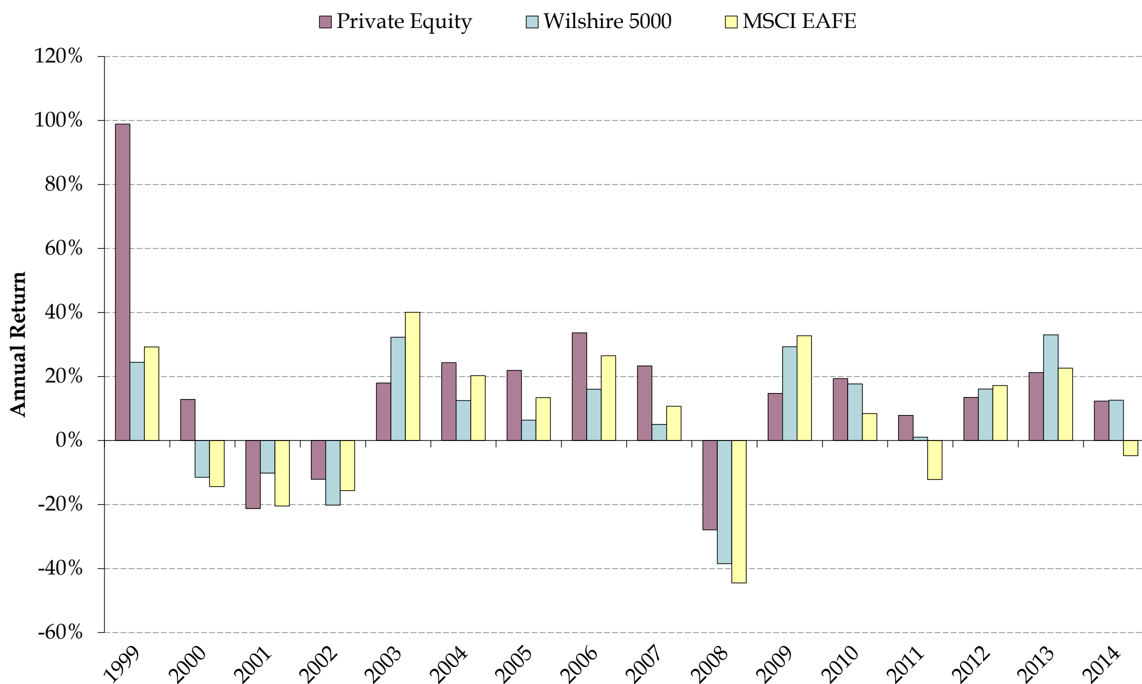


Source: Preqin

WHY INVEST IN PRIVATE EQUITY?

- Increase investment returns by "selling" unneeded liquidity to capital-constrained businesses.
- Achieve better alignment of interests between the owners and management.
- Improve the value of the asset by being a "control" investor.
- Private owners generally produce better financial results. (This is often ascribed to the inherent longer-term approach they take to management and capital expenditures.)
- Take advantage of the larger mispricing opportunities.
- Experience greater potential for (more persistent) alpha.

Calendar Year Returns for Public and Private Equities



Source: Cambridge Associates

WHAT RETURNS CAN INVESTORS EXPECT?

Historically, private equity investors have tended to earn 2% to 5% per year more than investors in comparable common stocks, even after paying substantial management fees and other 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, which they usually have expertise and a track record in achieving.

Different sectors of the private equity market have produced different returns, as shown in the table below.

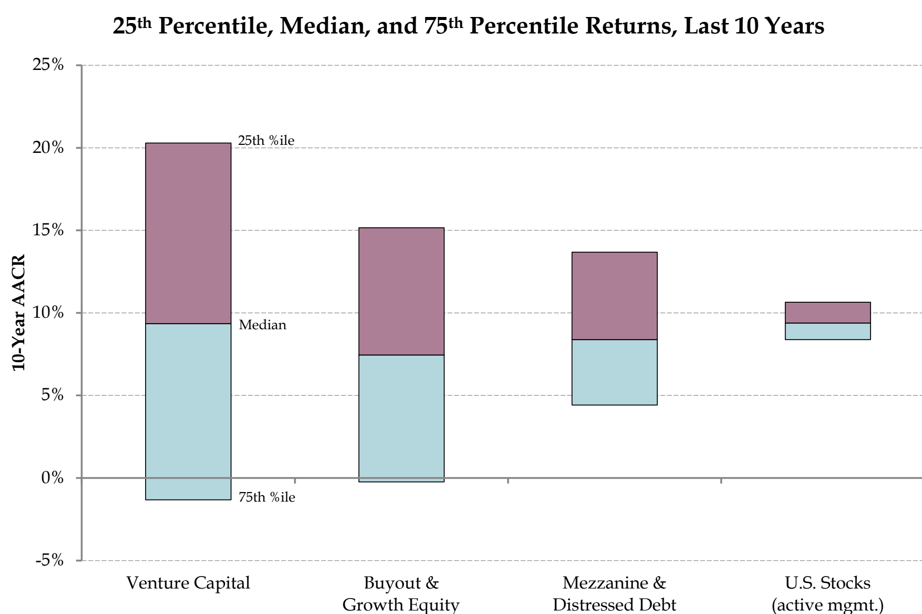
July 1986 – March 2015	Venture Capital	Buyouts & Growth Equity	Mezzanine & Distressed Debt	U.S. Stocks (Russell 3000)
Annual Average Compound Return	14.1%	13.8%	10.8%	10.0%
Annual Standard Deviation	21.0%	10.0%	8.0%	15.5%
Maximum Yearly Loss	-46.0%	-31.8%	-26.0%	-43.5%

HOW IMPORTANT IS MANAGER SELECTION?

Because of both the vast number of investable firms and the lower degree of readily-available financial and operational information about such firms, private equity is a much more inefficient asset class than public marketable assets. This means that skilled investment managers should be able to take advantage of the larger mispricing opportunities to add value. This is reflected in the wider dispersion of investment returns for different private equity sectors when compared with that of large cap equity managers.

Furthermore, exposure to private equity is not available via passive vehicles, but only through active managers. Since investors cannot "fall back" on mimicking the returns of a private equity index, and since there is so much potential value to be gained from picking an above-average manager (or to be lost from picking one that is below-average), manager selection is critical. There can be so much demand for managers with top historical performance records that access to their funds is often quite limited.

25th Percentile, Median, and 75th Percentile Returns, Last 10 Years



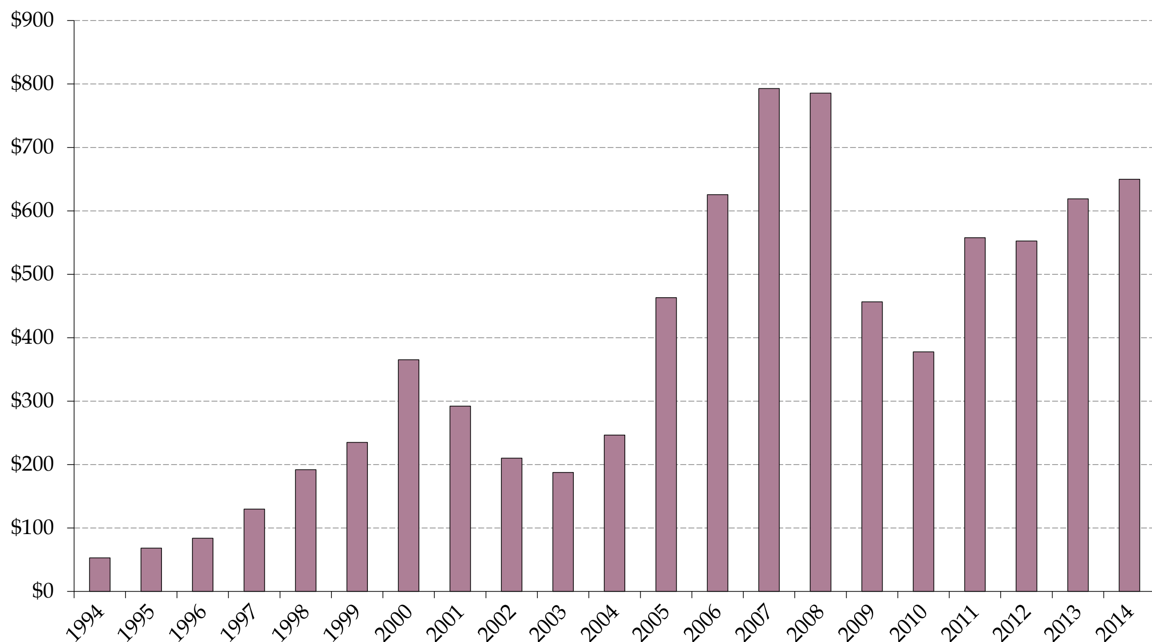
Last 10 Years	Venture Capital	Buyouts & Growth Equity	Mezzanine & Distressed Debt	U.S. Stocks (active management)
25th %ile Return	20.3%	15.2%	13.7%	10.7%
Median Return	9.4%	7.4%	8.4%	9.4%
75th %ile Return	-1.3%	-0.2%	4.4%	8.4%
Inter-quartile Spread	21.6%	15.4%	9.3%	2.3%
Value-add: 25th %ile over median	10.9%	7.7%	5.3%	1.2%

Source: Cambridge Associates, eVestment Alliance. Data for PE funds raised from 2005 through 2014 and U.S. equity managers for the trailing ten years as of 3/31/2015.

HOW LARGE IS THE PRIVATE EQUITY UNIVERSE?

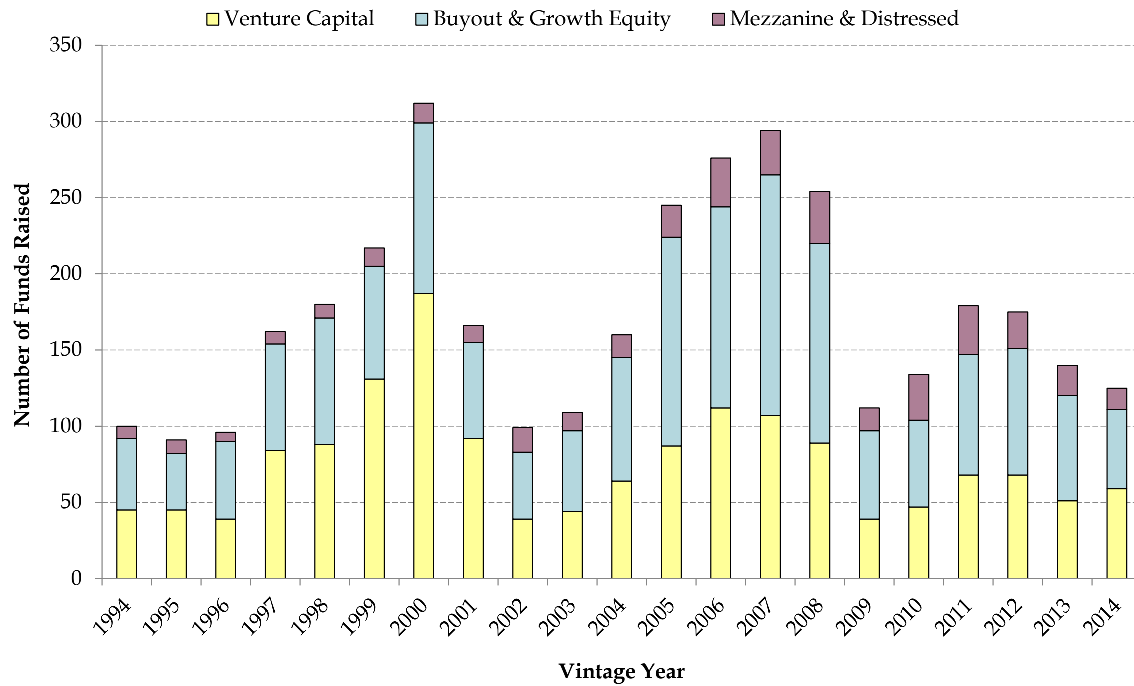
- The private equity marketplace has become increasingly developed and sophisticated, attracting institutional investors of all types.
- The private equity marketplace has reached a size at which it should not be ignored by institutional investors of sufficient scale.
- Annual commitments to private equity declined due to the Global Financial Crisis, but have since been on a steady rise and are forecasted to reach pre-GFC levels in the coming years.

Annual Commitments to Private Equity ($ billions)



Source: Cambridge Associates/ThomsonOne

Number of VC, PE/Buyout, and Mezzanine/Distressed Funds Raised, By Vintage Year



Source: Cambridge Associates/ThomsonOne

HOW DO PRIVATE EQUITY PARTNERSHIPS WORK?

The legal structure through which most institutions invest in private equity is a partnership. 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," by the end of which all of the investments must be liquidated and the proceeds returned to the investors.

An 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 investments. This three-to-five-year period during which the general partner makes its investments is known as the Investment Period. 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 investors might experience a small negative return, calculated as their initial investment minus the associated startup expenses. Because of these initial negative returns, which later turn positive (for profitable partnerships), a graph of returns is usually J-shaped. This so-called "J-curve" is normal and limited partners should expect this early in the partnership's lifetime.

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.

WHAT IS THE DIFFERENCE BETWEEN COMMITTED AND INVESTED CAPITAL?

Private equity partnerships require an advance commitment of capital; unlike liquid investments, these funds do not need to be sourced all at once when this legally-binding commitment is made. 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 as "reserves" 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 lessening exposure 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 at any given time, an investor must be prepared to commit $1.50 to $2.

Additionally, because committed capital is called only gradually, it takes a number of years for private investments to ramp up to their target allocation, in contrast with liquid investments that can be entered and exited swiftly.

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 and available opportunities, 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?

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 a limited need for short-term liquidity. However, there are many factors helping to create a secondary market for private equity partnerships. 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 net asset value (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 equity simply represents another equity asset class and another component of a fund's long-term strategic investment plan.

Private equity funds 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, being mindful of the fund's tolerance for illiquidity in a portion of its assets.
- 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 funds that is consistent with these objectives.
- Scrutinize each fund 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 funds, to ensure that 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 equity to maintain a 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.

HOW ARE COSTS AND FEES STRUCTURED?

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

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 net 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 net return of 8% on their initial investment, all future profits are distributed 20% to the general partner, and 80% to the limited partners.

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

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 advance 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. 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 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, performance evaluation then becomes more meaningful.

WHAT IS A FUND OF FUNDS?

To achieve adequate diversification, investors have two options. First, as described above, they can establish 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% per year, which is added to the 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 deducts their share of the profits.

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.* In addition, a fund of funds will have a longer term than individual funds, usually at least 13 years. They also tend to be less liquid in the secondary market.

CONCLUSION

Private equity investing is compelling primarily for its potential to produce higher returns, attributable to several drivers. First, investors should receive a premium for sacrificing liquidity. Second, there is enhanced alignment of interests between management and the owners, as private equity managers typically own a higher share of their firms than is the case for public companies. Third, control of an asset without accountability to short-term investors (and analysts) allows for long-term operational and governance improvement, leading to added value. Fourth, private equity managers have unique expertise and the ability to generate new wealth through growth. Fifth, private equity is an inefficient asset class with more opportunities to identify mispricings and persistent alpha. All these rationales are substantiated by the historical track record of private equity.

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.