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.

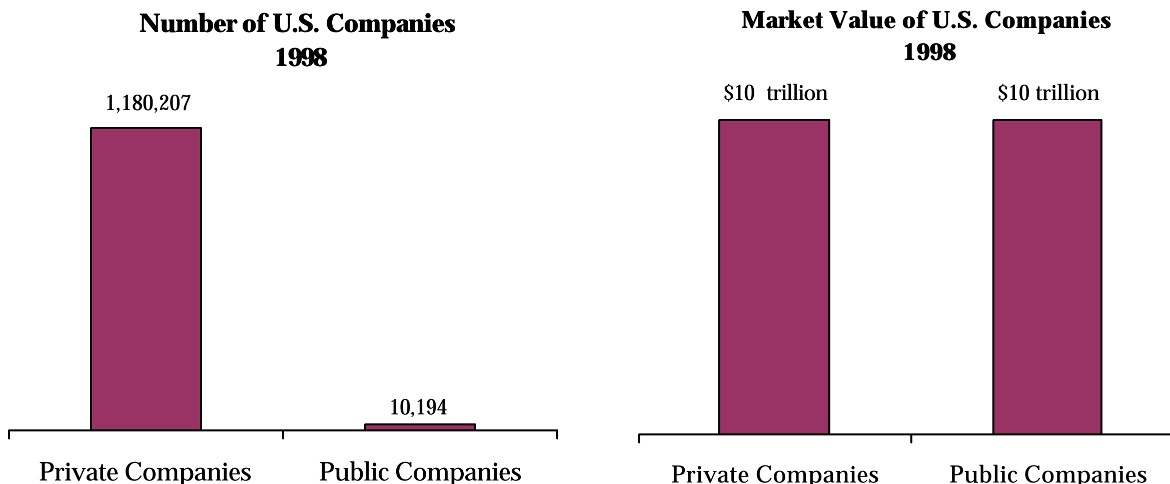
WHAT IS PRIVATE EQUITY?

Private equity investments are 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 a stake in a generative asset, i.e., an equity position. 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 low.

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. A fund should be invested across a variety of types of private equity investments to moderate risk.

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, as the following data illustrate. Thus, the private equity market provides a large arena for investing.

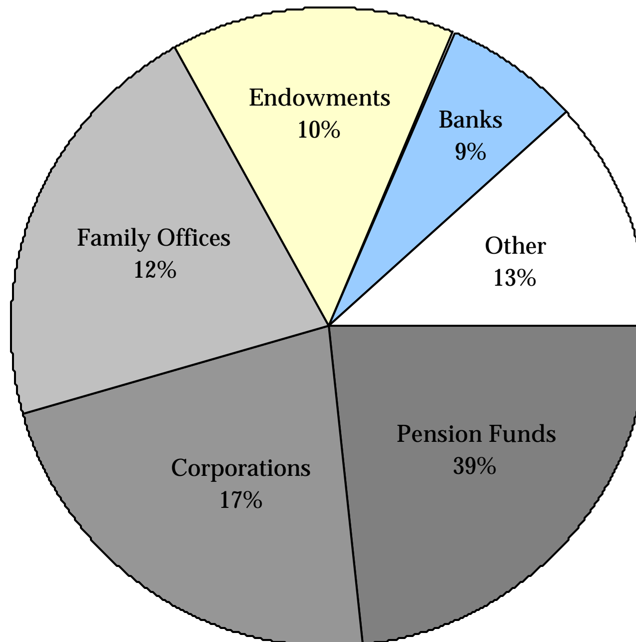


Source: U.S. Statistical Abstract, Dun & Bradstreet

WHO INVESTS IN PRIVATE EQUITY?

- Endowments, corporations, high-net-worth individuals, and retirement funds
- Investors seeking higher returns and enhanced equity diversification, beyond that available through the public stock market
- Long-term investors who are less concerned with liquidity
- Investors willing to accept greater or different risks

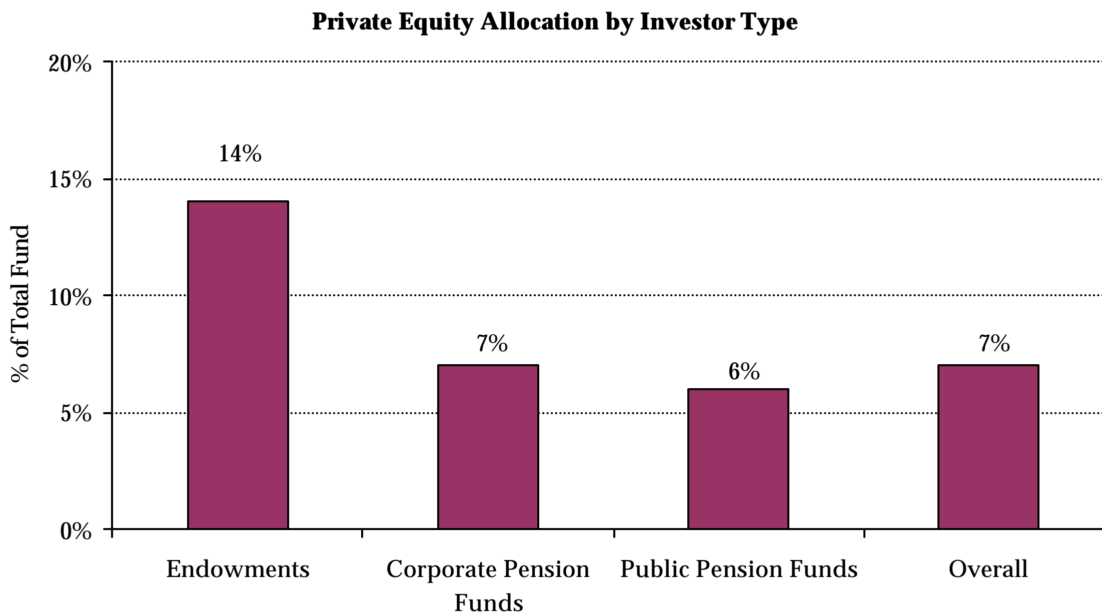
Private Equity Committments from 1995 through 1999



Source: Venture Economics, December 2000

HOW LARGE IS A TYPICAL INVESTMENT IN PRIVATE EQUITY?

- According to a survey conducted in 1997 by Goldman, Sachs & Company and Frank Russell, the average U.S. pension fund investing in alternative assets sets a target allocation of 6% to 7% for this asset class.
- To date, relatively few Taft-Hartley funds have invested significantly in private equity. The early institutional investors in private equity were endowments and large corporations.
- Many public funds (state and municipal government) now make substantial allocations to private equity partnerships.

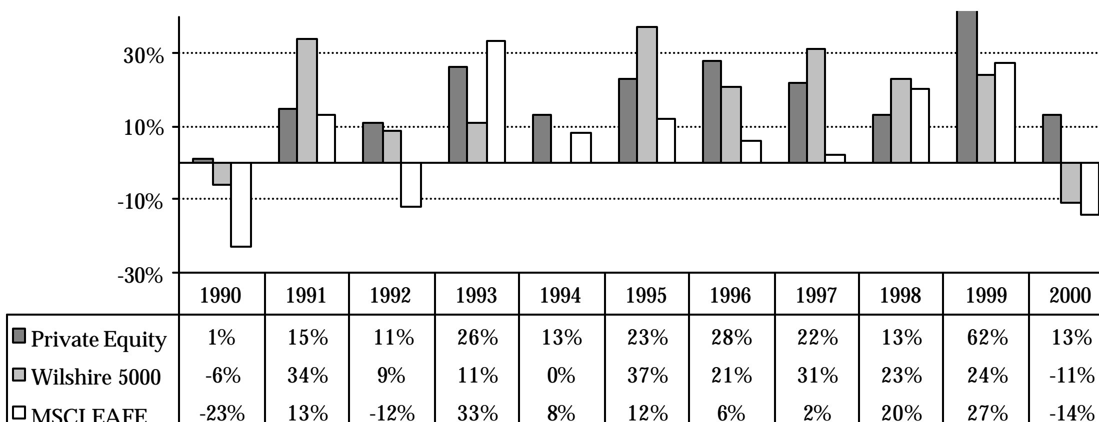


Source: Goldman Sachs/Frank Russell, 1999 Report on Alternative Investing

WHY INVEST IN PRIVATE EQUITY?

- Increase investment returns by “selling” unneeded liquidity to capital-needy businesses.
- Enhance diversification by investing in businesses or industries not represented fully in the public security markets.
- Reduce return volatility by investing in private assets whose returns are uncorrelated with those of publicly traded assets.

Annual Returns of Equity Classes



	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Private Equity	1%	15%	11%	26%	13%	23%	28%	22%	13%	62%	13%
Wilshire 5000	-6%	34%	9%	11%	0%	37%	21%	31%	23%	24%	-11%
MSCI EAFE	-23%	13%	-12%	33%	8%	12%	6%	2%	20%	27%	-14%

Source: Venture Economics, August 2001

The data above illustrate that private equity investments are very weakly correlated on an annual basis with domestic public equities (the Wilshire 5000 index) and foreign public equities (EAFE index), and yet offer similar cumulative returns. Because of these relationships, private equities are an excellent vehicle for increasing the scope and diversification of an equity investment program.

WHAT RETURNS CAN INVESTORS EXPECT?

Historically, private equity investors have tended to earn 3% 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 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 rapid growth.

- 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 enhancing long-term shareholder value without fear that their stock price will be battered by short-term market expectations.

- 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.

- Note that different sectors of the private equity market have produced very different returns. The riskiest segments (e.g., early stage venture) tend to produce the highest long-term returns.

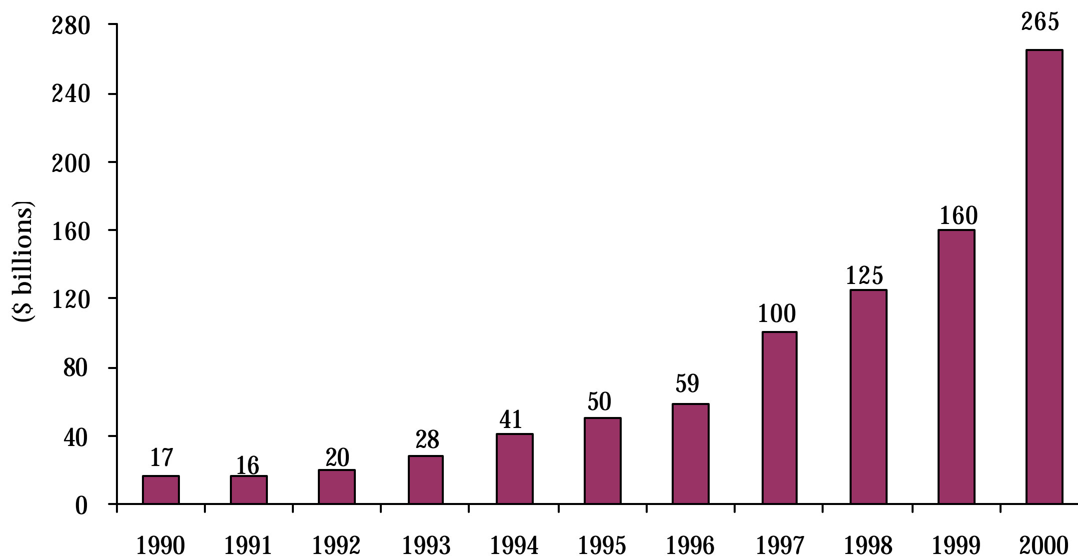
	Trailing 10-Year Annualized Return Ending December 31, 2000[1]	Trailing 20-Year Annualized Return Ending December 31, 2000
Private Equity	**21.4%**	**18.9%**
Wilshire 5000	17.0	14.8

[1] Private equity performance figures from Venture Economics, August 2001.

WHY INVEST IN PRIVATE EQUITY NOW?

- During the 1990s, the private equity marketplace became increasingly developed and sophisticated, attracting institutional investors of all types.
- The private equity marketplace has reached a size at which it cannot be ignored by institutional investors of sufficient size.
- Many funds have benefited from very strong returns from the public stock market during the current bull market. They are now in a position to take advantage of the opportunities for diversification available within the private equity marketplace.

Institutional Commitments to Private Equity



Source: Venture Economics, August 2001

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," after 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, the partnership is known as a "blind pool." Virtually all private equity partnerships begin as blind pools.

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.

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 private firms. Thus, each partnership is actually a collection, or portfolio, of individual company investments, not a single investment.

At the beginning, the investments are 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.

COMMITTED VERSUS INVESTED CAPITAL

Private equity partnerships require an advance commitment of capital. This 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. 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. One rule of thumb developed over the past decade says that in order to have $1 actually working in private equities, an investor must be prepared to commit almost $2.

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 must 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 ten 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 no 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.

Today, there is a small, but rapidly growing secondary market for private equity partnerships. Over the next decade, Meketa Investment Group expects the secondary market for private equity partnerships to grow and become increasingly efficient. This secondary market creates liquidity for existing investors, but also offers new investors in the asset class 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 return targets and goals.
- Build an investment program consisting of a diversified group of individual private equity investments.
- Scrutinize each investment closely, to identify its unique characteristics and risks. This includes a thorough legal review of the investment's terms. Note that because private equity partnerships are not registered with the SEC, 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 the same as those that are appropriate 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 IPOs or sales, 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 absorb the liquidation proceeds of maturing partnerships. This process is complicated by the nearly random 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 "custom tailored" pool of partnerships. The main disadvantage of this method is administrative: selecting and maintaining 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. Funds-of-funds are relatively new, but are likely to grow as more institutional investors seek a simpler, "one-stop" option for investing in private equities.

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, much like a mutual fund. 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 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 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 diversification and professional management. A fund-of-funds may invest in fifteen or more sub-funds, each of which may consist of twenty 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 sub-funds deduct their share of the profits.

Funds-of-funds can be very large, with most ranging in size from $500 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. However, since most funds of funds are new, with no significant investment record, it is not clear whether such an advantage actually exists.

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 sub-funds, thus investing across calendar years and vintage years at the sub-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. In this regard, private equity partnerships are more like real estate investment partnerships, and like real estate, the fees are much higher. Fortunately, the higher fees can be offset by the higher potential returns.

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

The second type of fee is called "carried interest," and 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 10% and a carried interest of 20%. This means that as soon as the limited partners have received a return of 10% on their initial investment, all future profits are distributed 20% to the general partner, and 80% to the limited partners.

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.

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 fine-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 are carried at cost until a formal appraisal or transaction (i.e., additional financing or a private or public sale) results in the realization of a gain or loss on the initial 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, the investor's December 31 valuation actually reflects a June 30 valuation for any private equity assets held. Once private equity investments are realized, usually over a period of five or more years, then performance evaluation becomes more meaningful.

CONCLUSIONS

The case for investing the majority of any long-term investment program in equities is compelling. Equities represent the direct ownership of the real, generative assets of society. Only real assets, and not bonds, are likely to grow in value over time as societies grow and create new wealth.

Private equities have a high long-term return potential like publicly traded stocks, but little or no measurable interim volatility. Further, the return patterns of private equities over short periods of time are very weakly correlated with the returns of public equities, both domestic and foreign. As a result, private equities are an excellent means to expand the scope and diversification of a long-term equity investment.