North Sky
CAPITAL

Fourth Quarter 2013

Smart Allocation Strategy vs. Front-Running the Herd

We humans are a quirky lot, including when it comes to investing. We have a proclivity for hopping from one trendy investment to the next, a never-ending game of trying to be ahead of the pack to achieve excess returns from some new, overlooked or orphaned investment class (before everyone else shows up to ruin the fun). Typically, the new "new thing" arises when a high-profile investor, author or research professor proclaims that the next investment trend is going to be "X" and a few people take notice and then they tell a few friends and they tell a few friends…until the folks at CNBC proclaim that the "smart money" is now investing in the BRICs or secondaries or managed futures or European distressed debt, etc. The market chatter is always about what might be around the corner and how we should position our money ahead of that event. "Something bad is going to happen in 'Y' asset class so you better start moving money to 'Z' asset class." Or, "The Fed is going to change policy soon so start rotating out of 'A' and into 'B'." The talking heads are often wrong but never in doubt.

All of this is prelude to suggest that rather than chasing the latest "new thing" or letting emotion creep into investment decisions, it is better to concentrate on getting the basics right—like diversification, asset allocation and selecting talented investment advisors. If so, the rest often takes care of itself.

We encourage a long-term view to investing in general and consistently communicate the following important points about private equity ("PE") in particular:

1. PE should have greater returns than stocks and bonds over the long-term
2. PE is an important diversification tool for institutional investors
3. Invest consistently in PE, making new commitments every year

Let's take each of these in turn.

PE Returns > Stock and Bond Returns

Historically speaking, PE investments generate higher returns than public debt or equity investments. And they should. PE firms have the ability to invest in early stage companies that are developing technologies that have the potential to be highly-profitable (e.g., a cancer drug or the next Tesla or Twitter), or relatively more mature companies that have yet to be optimized (e.g., a family-owned manufacturing business) or fully mature businesses that are currently undervalued. Immediately following the investment, PE firms set about directly helping those companies to grow and create shareholder value—often over a period of 2-5 years. As you know, PE firms usually employ a stable of operational, marketing, financial, HR and other experts who add value to portfolio companies by upgrading their IT systems, improving their financial controls and personnel, enhancing the supply chain and distribution channels, etc. Also, most of this work is done unencumbered by the regulatory red tape and short-term thinking that comes with being a publicly-traded company on a US stock exchange. PE firms can make medium-term and long-term plans for the company and execute those plans without being beholden to the quarterly earnings and transparency demands of stock analysts and institutional investors. In addition, PE firms ought to be delivering better returns than one would get in the public markets because investors should be rewarded for locking up a portion of their portfolios for a period of time. To be clear, there will be short periods of time when the stock or bond markets outperform private equity returns, but over the long haul PE ought to produce higher

returns—which is the very reason so many endowments, foundations, pension plans and other institutional investors view PE as a critical means of attaining their investment objectives.

PE Returns vs. Stock and Bond Returns

Index	10 Year	20 Year	25 Year
Cambridge Associates LLC U.S. Buyout Index[1]	14.3%	12.8%	12.7%
Cambridge Associates LLC U.S. Venture Capital Index[2]	7.8%	30.1%	19.8%
S&P 500 Index[3]	7.3%	8.7%	9.8%
Barclays Government/Credit Bond Index[4]	4.4%	5.9%	7.0%

1- Cambridge Associates as of 6/30/2013. The index is an end-to-end calculation based on data compiled from 674 U.S. buyout funds, including fully liquidated partnerships, formed between 1986 and 2013. Net of fees, expenses, and carried interest.
2- Cambridge Associates as of 6/30/2013. The index is an end-to-end calculation based on data compiled from 1,439 U.S. venture capital funds (931 early stage, 160 late & expansion stage, 342 multi-stage and 6 venture debt funds), including fully liquidated partnerships, formed between 1981 and 2013. Net of fees, expenses, and carried interest.
3- As of 6/30/2013. Source: Cambridge Associates LLC.
4- As of 6/30/2013. Source: Cambridge Associates LLC.

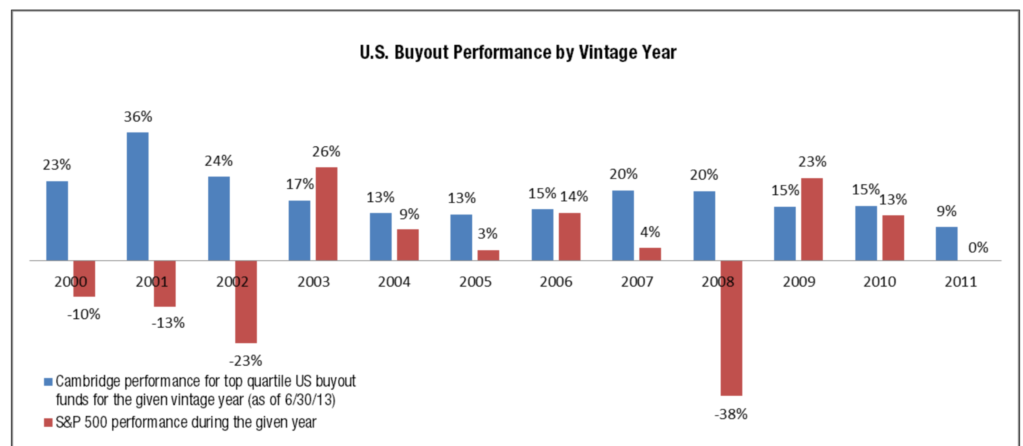
PE is an Important Diversification Tool

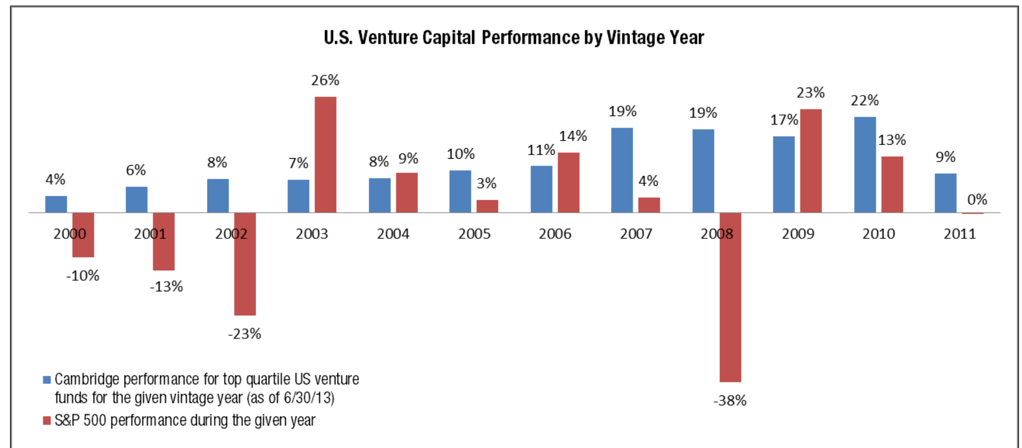
Adding PE to an otherwise diversified portfolio, reduces overall volatility (beta). According to Cambridge Associates PE fund of funds data, the standard deviation of IRRs from 1997-2010 was just 8.2%. It was 20.7% for the S&P 500 over the same period.

It is also worth pointing out that the risk of loss of principal by investing in a PE fund of funds is pretty remote due to diversification—typically 10 managers for our funds of funds for example. Furthermore, while we have seen instances of a substantial or even total loss of principal when an investor has chosen a less diversified approach in terms of the number of PE funds or vintage years, a total loss of capital in a PE fund of funds has never happened as far as our research could find. This shows the important diversification and investment selection insights of funds of funds.

Consistency Matters – Invest in PE Every Year

The crystal ball you use to perfectly time your public equity buy-sell decisions is just as accurate when applied to your private equity investment decisions. All too often, investors make what seems like erratic investment decisions when it comes to private equity. There is a distinct tendency to make new commitments to PE when the public markets have been favorable but NOT to make new commitments when the public markets have been underperforming. This is human nature. We spend money when we feel richer; we spend less when we feel poorer. However, evidence shows that the best PE returns—the truly outstanding years— often come from the vintages that coincide with an underperforming stock market (or a poor economy in general).





Conclusion

PE is one of the most important asset classes for endowments, foundations, pension plans and wealthy individual investors planning for their own retirements. PE plays a critical role in terms of investment return and diversification. Furthermore, by making new PE investments every year, investors will capture the big upside years that private equity has shown it can deliver. This strategy protects investors from human nature that too often leads to investing at the top of the cycle and/or not investing at the bottom when returns can be outstanding. A consistent PE investment strategy will also help avoid chasing the latest investment trend or headline of the day.

We believe PE in the medium- and long-term will (1) deliver higher returns than traditional asset classes, (2) provide a lower-correlated asset class, thus reducing portfolio volatility, and (3) create ground-breaking new companies and fund the growth of other dynamic companies that will create social value, beyond investment returns.

Finally, while there are many benefits of investing in PE, the selection of a PE manager is also critically important. Understanding which firms are best positioned *today* to potentially produce outsized returns *tomorrow* takes a lot of time and effort. We hope you will let us help you with your private equity allocations in 2014 and beyond.

Quote of the Quarter

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." --Samuel Langhorne Clemens

Upcoming Events

We are regular speakers and attendees at key industry conferences. We hope to see you at these upcoming conferences:

January 13-26	**North American International Auto Show,** Detroit, MI www.naias.com
February 10-11	**Made in America Summit,** Lake Buena Vista, FL www.frallc.com

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