Alternative Assets - Private Equity and the Use of Fund of Funds

North Sky
CAPITAL

FALL 2011 RESEARCH REPORT

ALTERNATIVE ASSETS – PRIVATE EQUITY AND THE USE OF FUNDS OF FUNDS

Introduction

Alternative assets play important portfolio diversification and absolute return roles for investors such as pension funds, endowments, foundations, corporations, family offices and high net worth individuals. Private equity funds, hedge funds, real estate, real assets and commodities represent some of the alternative assets that investors can use as a means to diversify and to seek higher returns for their portfolios. In this Research Report, we explain what private equity has to offer, answer many of the questions being asked by investors today and explain why now may be an opportune time to make a commitment to a private equity fund of funds, particularly for investors who are new to this asset class.

Sophisticated investors realize that private equity offers important benefits, including:

- *Potential for high investment returns,*
- *Low correlation to traditional investments and*
- *Tax efficiency (for family offices and other taxable investors).*

Although new commitments to private equity slowed due to the economy in 2009-10, commitments in 2011 and 2012 are expected to increase. We believe investing in private equity during these transitional times can generate strong returns.

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WHAT IS PRIVATE EQUITY?

Private equity is an alternative asset class that has become a mainstream component of most institutional portfolios. In the broad sense, private equity means an equity security that is not registered with the SEC and is not publicly traded on an exchange. The more common usage of the term, however, refers to leveraged buyout ("LBO") funds and venture capital ("VC") funds, which make highly structured investments in predominantly private companies. Some current and former private equity-backed private companies include: Google, Netflix, Lululemon, Facebook, Twitter, Apple, FedEx, Groupon, Intel and Zynga.

In general, a private equity fund (LBO and VC) is structured as a limited partnership that consists of a private equity management firm (the General Partner or "GP") and Limited Partners ("LPs"), who have limited liability and are not involved in the day-to-day operations of the fund. Most private equity firms use similar processes of fundraising, investing and exiting businesses or assets.

- **Fundraising.** Private equity firms will raise a fund by securing capital commitments from LPs. LPs include pension plans, endowments, foundations, insurance corporations, high net worth individuals and family offices. The length of the fundraising process depends on many factors including the fund size, current economic conditions and the firm's pre-existing relationships with LPs.
- **Investing.** The GP will invest the fund's capital in a number of businesses or assets and hold either a majority or minority stake depending on the fund's strategy. The GP will work to add value to each investment by creating operational efficiencies, further developing new products, hiring and training appropriate management teams and other initiatives.
- **Exiting.** After a targeted holding period (e.g., 3-6 years) a private equity firm will work to exit the investment to generate a return, most often through a sale to a larger acquirer or an Initial Public Offering ("IPO").

Professional private equity firms often review hundreds, in some cases thousands, of potential investments each year. They utilize rigorous due diligence efforts to analyze each potential investment to determine which ones fit the fund's strategy and afford the best investment opportunities. They also use a variety of structuring methods (e.g., preferred stock, liquidation preferences and anti-dilution provisions) to reduce risk and increase the probability of favorable returns. Investments by LBO funds and VC funds bear many similarities but there are distinct differences.

- **Use of leverage**. LBO funds typically use leverage (debt) to finance a transaction. They use their own capital to purchase part of a company (e.g., 25-40%) and debt to purchase the rest. Generally, the assets of the company are used as collateral for the debt, and the cash flow of the company is used to pay down the debt balance over time. VC funds, on the other hand, typically use no debt and own a minority position in the company. In addition, VC funds tend to invest incremental capital into a company over time as the business matures and requires additional growth capital; whereas businesses in which LBO funds invest do not typically require incremental capital beyond the initial investment.
- **Investment stage**. LBO funds tend to invest in mature companies with stable cash flows and established products/services. VC funds usually invest much earlier in a company's life cycle, with the purpose of helping the company develop its product, hire appropriate personnel and grow the company into a thriving business.
- **Industry**. LBO funds tend to invest in established companies, many of which happen to be in mature industries like manufacturing, services and consumer products. VC funds tend to invest in technology, clean technology and healthcare companies because the constant innovation in these areas creates a steady flow of new companies and growth opportunities.

BENEFITS OF ADDING PRIVATE EQUITY TO A PORTFOLIO

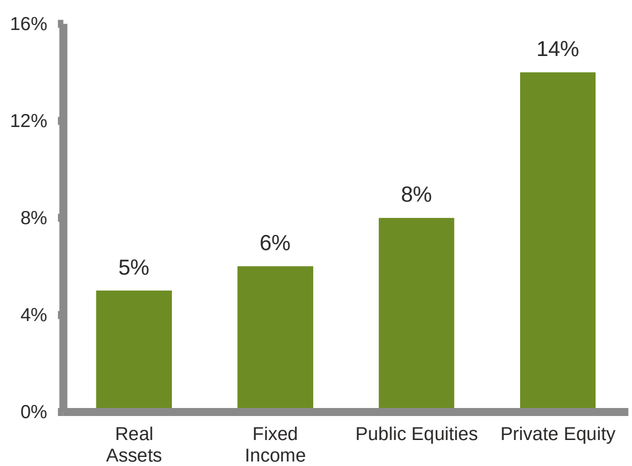
Potential for High Returns

LBO and VC funds offer potentially higher returns and attractive elements of diversification to many investors. The private equity market remains relatively inefficient and offers the potential for premium returns versus the public debt and equity markets.

In the public markets, company information is freely available, companies are valued in real time and trading markets provide nearly instantaneous liquidity.

By its very nature, however, the private market is less efficient. Company information is not in the public domain, valuations occur only periodically and liquidity events, such as IPOs or mergers and acquisitions ("M&A"), often occur years after the initial investment. To compensate for these factors, private equity investors have historically been rewarded with returns in excess of those in the public markets, which is laid out in the following graph.

Chart 1: Annualized Twenty Year Performance by Asset Class[i]



Low Correlation to Other Asset Classes

Interestingly, private equity returns do not appear to be highly correlated to public debt and equity returns. For example, the Red Rocks Listed Private Equity Index ("LPE") had a –75% historical correlation to U.S. Bonds and only a 45% historical correlation to U.S. Stocks[ii]. Because private equity has a relatively weak correlation to many of the primary building blocks of an otherwise diversified portfolio, it may be used to improve a portfolio's overall returns and/or to reduce its volatility.

Tax Efficiency

For family offices and other taxable investors, it should be noted that private equity investments are highly tax efficient because of the relatively longer holding periods. Most private equity fund managers invest in individual companies with the expectation of helping those companies become more cost-efficient, grow, develop new products, enter new markets, etc. This is a labor-intensive process that may take several years to accomplish; a typical holding period for a portfolio company ranges from three to six years. Although there are exceptions, the vast majority of private equity gains occur after a holding period of more than a year. Therefore, gains from private equity investments tend to be taxed at the lower rate assigned to long-term capital gains.

Favorable Conditions Exist Today

For investors, the last ten years have been challenging, to say the least – public equity returns have been well below historical norms and bonds, the backbone of all our pension and 401k plans, are now yielding essentially zero on a real basis. But innovation and opportunity have continued to arise within private equity, whether it be in social media companies like Twitter or Zynga or private distressed debt funds that have taken advantage of conditions in 2008-2009.

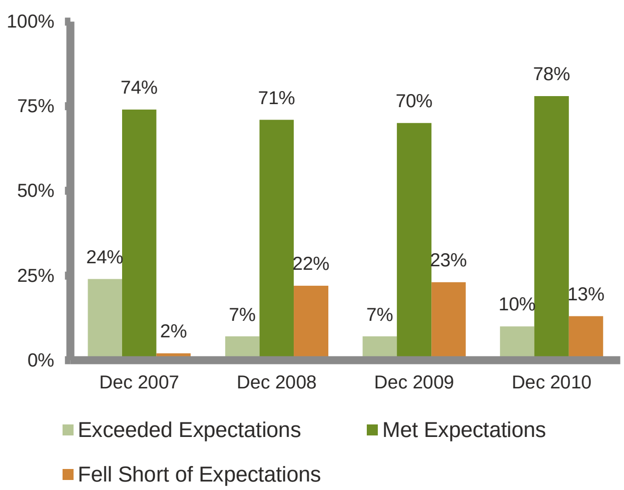
A brief look back at some of the major data points since 2008:

- The global economy suffered the worst economic and financial crisis since WWII.
- The government debt crisis in Europe led to bailouts of Greece, Ireland and Portugal.
- U.S. unemployment levels reached their highest levels since 1983.
- U.S. housing starts reached their lowest levels on record.
- The Dow Jones Industrial Average and the S&P 500 fell to their lowest levels in nearly 15 years.
- Gold prices hit an all-time high of over $1800 an ounce.

- Private equity funds generally slowed their investment pace, focused their efforts on supporting existing portfolio companies.

Despite the tumult of the last few years (and in part because of it), institutional investors continue to invest in private equity. Chart 2 shows that the vast majority of leading private equity investors are satisfied with their private equity returns. The average allocation to private equity from the 20 largest U.S. public and private pension plans is 5.8% and 5.9%, respectively[iii]. In addition, four of the largest university endowments (Harvard, Yale, Princeton and Stanford) allocated an average of 20% of their portfolios to private equity in 2010 – allocating 13%, 30%, 23% and 12%, respectively[iv].

Chart 2: Investor Satisfaction with Private Equity Portfolio Returns[v]



U.S. foundations and endowments have long been considered the most successful global institutional investors[vi]. These institutions have kept private equity as one of their top asset allocations. The Yale Endowment recently described its long-term view of this asset class:

"Private equity offers extremely attractive long-term risk-adjusted return characteristics, stemming from the University's strong stable of value-added managers that exploit market inefficiencies…Since inception [1973], private equity investments have generated a 30.4% annualized return to the University[vii]."

Whether you already have an existing private equity program or are considering starting one, the following may provide encouragement for making new private equity commitments in the near term:

- Many veteran private equity firms believe the biggest opportunities emerge in times of transition out of an economic downturn. These firms have reported that they are particularly optimistic about the new investments they are making today. In many cases, we are seeing low valuations, favorable deal terms, an improving senior lending market (for LBO funds), innovative companies/business plans (for VC funds), reduced fixed costs, cheaper labor and strong management talent as part of deal pipelines.
- Many M&A experts believe there is a tremendous backlog of buyout opportunities, which have been accumulating during the last three years of economic uncertainty.
- Following the downturn caused by the global financial crisis in mid-2008, market conditions have started to improve, allowing private equity firms to exit some of their investments made during the boom era. During 2010, 145 IPOs occurred with an aggregate value of $38.7 billion, twice the aggregate value seen in 2009, and a twelve-fold increase in comparison to 2008[viii].

We believe some of the biggest opportunities in the market today lie in the Lower Middle Market Buyouts and CleanTech Growth Equity sectors. We identify these two sectors as being outperformers in the current private equity environment for reasons discussed below.

Lower Middle Market Buyouts

- Purchase price multiples have historically been lower than Mid-Market and Mega LBOs.
- By their nature, lower middle market companies benefit tremendously from investors with operational expertise that may have been lacking in the company.
- The universe of potential deal flow is immense, allowing private equity firms to pursue the very best opportunities.

- Current level of capital overhang is putting pressure on Mid-Market and Mega LBO firms to invest their dry powder which should result in attractive exits for Lower Middle Market investors.

CleanTech Growth Equity

- CleanTech includes the following sectors: alternative energy, energy efficiency, water technology, advanced materials, transportation, agricultural advancements and recycling.
- Primary drivers: global population growth, urbanization in developing nations and aging infrastructure.
- Global demand for energy, water and other natural resources is increasing and many traditional resources are becoming scarce.
- Many mature CleanTech companies – those with proven technology and significant customer traction – exist around the world and need growth capital.

PRIVATE EQUITY QUESTIONS

Despite its acceptance as a mainstream investment category, private equity continues to suffer from certain concerns and misconceptions. Three of the most common questions we are asked are discussed below:

Are All the Good Deals Gone?

The global financial crisis and the following recession brought deal flow to a near standstill from late 2008 to early 2010, but activity is increasing and there are investment opportunities available today that we expect will produce significant investment returns. While the investment pace may have slowed recently, innovation continues, new companies are started each day and business lines, divisions of companies, private equity-backed businesses and family owned companies are seeking growth capital or being sold for a variety of reasons.

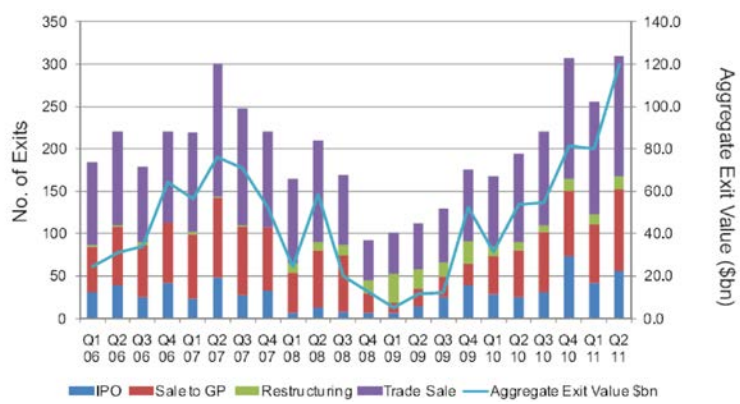
"Going private" transactions are also gaining popularity among public companies as a way to eliminate costly reporting requirements resulting from Sarbanes Oxley and to focus on long-term growth rather than quarterly results. Often-times, public companies will partner with private equity firms to take advantage of a firm's experience and expertise in implementing long-term growth strategies. There have been over 100 "go-private" transactions in the U.S. since the beginning of 2009, including some well-known companies such as California Pizza Kitchen, Epicor Software, Jo-Ann Stores, Del Monte Foods, J.Crew, Gymboree and Burger King[ix].

Fundraising efforts by private equity firms are also picking up. Many investment professionals believe the best time to be a buyer of businesses and assets is post-crisis. For these reasons, private equity firms are once again hitting the road to raise new funds in order to capitalize on the current market environment and put money to work in promising new investments. As of Q2 2011, there were 1,665 funds in the market seeking aggregate commitments of more than $673 billion[x].

Are There Exit Opportunities?

A private equity return is realized when the investment is sold to another buyer or is taken public in an IPO. LBO firms historically have used the M&A market for the vast majority of their liquidity events. VC firms have historically used both routes to maximize value opportunistically through different economic and investment cycles.

Chart 3: Number of Private Equity-Backed Exits by Type and Aggregate Exit Value[x]



As shown in Chart 3, global M&A and IPO activity is increasing, following the extreme downturn of the global financial crisis. M&A activity has drastically accelerated since late 2008 with 309 private equity-backed buyout exits valued at $120.1 billion in Q2 2011.

In addition, the overall increase in IPO activity has led to an increase in private equity-backed exits through IPOs. In 2010, 17% of private equity-backed exits came from IPOs compared to 15% in 2009 and only 5% in 2008[xi]. The recent increase in both M&A activity and IPO activity are strong signs that exit conditions in the industry are improving.

Private equity investing is a long-term process. It typically takes several years from the date of investment to build a company and prepare it for a sale to another buyer or take it public in an IPO. The M&A and IPO markets will ebb and flow with the economy, but for now, exit opportunities are quite strong.

Isn't There a Capital Overhang?

Due to the tremendous amount of capital raised by private equity firms during 2005-2008, some industry commentators have questioned if fund managers have raised too much capital to prudently put it all to work. The U.S. private equity overhang stood at $376 billion at the end of 2010, with more than 60% from funds raised in 2007 and 2008 alone[xii]. Although the current amount of overhang is high by historical standards, it has been declining in recent quarters from its high of $445 billion at the end of 2009[11].

The most frequently voiced concern about this overhang is that there might be too much money chasing too few good deals. A typical private equity fund is mandated to make its investments in the first five years of the fund's life. This means that funds that were raised in 2007 and 2008 are coming to the end of their investment periods and fund managers may rush to get a deal (any deal) done before the investment period expires. The fear is that this could drive up valuations, fund managers may overpay, companies that would not normally merit investment may now be funded, competition may be overheated and investment returns may suffer.

Despite many firms having large pools of available capital, most firms appear to be very cautious about making new investments today. Entrepreneurs across the country complain about how extraordinarily difficult it is to secure VC funding because of this cautiousness and the heightened scrutiny imposed on VC investments. The standards tend to be similarly high on the buyout side.

Certainly, many private equity funds have and will continue to exhibit less than stellar discipline when making investments. It is imperative for private equity investors to ensure the funds in which they invest are being run by managers who are maintaining investment discipline.

BENEFITS OF FUNDS OF FUNDS

Funds of funds pool investors' capital and commit that capital to a portfolio of underlying private equity funds. We believe a fund of funds approach is a prudent way to invest in private equity for all but the largest institutions. Most funds of funds offer a variety of benefits, including:

- Access to elite funds and knowledge of emerging funds that have the potential to achieve top quartile performance.
- Ample diversification across funds, vintage years, sectors and companies.
- Professional fund selection by a full-time team with the necessary resources, experience, in-sight and relationships to make informed investment decisions.
- Lower cost (it is generally less expensive to outsource this specialized service).
- Higher return expectations with less risk.

A discussion of these benefits appears below.

Access to Elite Funds and Identification of Emerging Funds

Many investors, particularly investors who are new to this asset class, have difficulty accessing the leading LBO and VC funds because such funds are not open to the general public or the minimum commitments are too high. Private equity is still an inefficient opportunity, where past relationships provide access to funds in high demand and newcomers are often turned away. Frequently, when a well-established private equity firm with a strong track record raises a new fund, investors in its prior funds will jump in to support and quickly oversubscribe it.

Most top firms give priority allocations to their previous investors but may also allocate a small portion of a fund to a select group of new investors. Whether a fund of funds can provide access to this elite tier of private equity funds will depend on the strength of their past relationships with such firms or the value they bring as strategic investors.

Fund of funds managers who are active in the private equity community may also have important insight regarding up-and-coming private equity firms. The private equity industry undergoes turnover like any other industry. Each year a handful of seasoned investment professionals leave established firms to start their own firms. While judging the merits of new firms requires extra time and skill, finding the right combination of personalities, deal flow and technical expertise can be worth the extra effort. Strong funds of funds managers have expertise and perspectives that enhance their abilities to make informed judgments about the prospects of these new firms and play an important role in identifying emerging firms that may join the ranks of the elite firms.

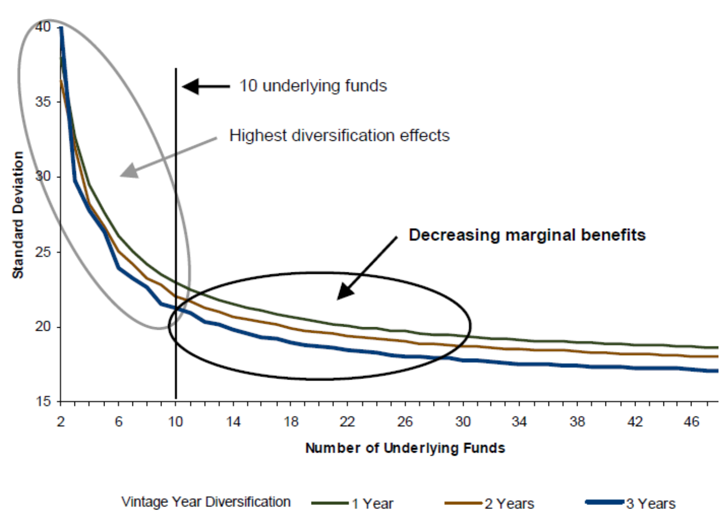
Diversification

Funds of funds are diversified across a number of different private equity funds. This is important for investors who may otherwise have difficulty committing to more than one private equity firm because of the high minimum commitments top firms require (often $5 million or more per fund). In order to avoid the inherent risk of investing in a single fund manager, sophisticated investors make commitments to multiple private equity funds or use a fund of funds.

Other diversification strategies vary among funds of funds managers. Some managers are broadly diversified by investment strategy (VC, LBO, mezzanine, distressed, secondaries), industry sectors (manufacturing, technology, healthcare, consumer products) and investment stage (seed, early, late). Niche players offer subsets of these classifications, such as a fund of healthcare VC funds or a fund of European LBO funds. Large institutions may use these niche players to supplement a specific allocation in their overall portfolio, but smaller investors generally tend to favor broadly diversified domestic funds of funds.

Finding the optimal level of diversification is important in maximizing returns and avoiding over-diversification. Studies show that portfolio volatility (standard deviation) decreases as the number of funds and the vintage year diversification are both increased; however, the incremental benefits of diversification diminish with each addition. For example, as shown in Chart 4, a portfolio of three underlying funds spread across three vintage years (i.e., one fund in each year) has a standard deviation of 30%, while a 10-fund portfolio and a 20-fund portfolio spread across three vintage years has a standard deviation of 21% and 19%, respectively. This data shows there is a substantial benefit by investing in a 10-fund portfolio relative to a 3-fund portfolio, but there is only a modest incremental benefit by investing in a 20-fund portfolio to a 10-fund portfolio. This leads us to believe that more is only better to a certain extent (e.g. 8-10 underlying funds and 2-3 vintage years of diversification); however, the incremental monitoring costs tend to favor a fund with approximately 10 funds.

Chart 4: Optimal Diversification – Venture Fund of Funds[xiii]



Professional Fund Selection

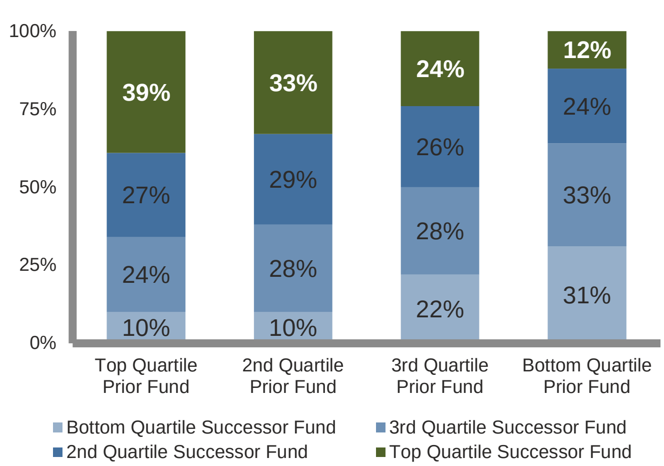
Private equity investing is a highly specialized field that requires professional expertise; investors either develop this expertise internally or outsource it to a fund of funds manager. The nation's largest pension funds, foundations, endowments and insurance companies have the scale to justify in-house teams; many other investors do not.

There are a few thousand private equity firms in the U.S. today. Each has a unique deal flow network and most claim to review hundreds, if not thousands, of high-quality deals each year. Firms appear to have impressive investment professionals with post-graduate degrees from prominent universities and significant experience, financial acumen and industry expertise. Without a discerning eye, many start to look the same especially when accompanied by marketing materials accentuating the positives.

Median to top quartile investment return spreads can be large, making identifying a top performing fund even more valuable. Preqin reports that the average return spread between private equity median and top quartile performance across 1992-2008 vintage years was 10.6%. In other words, selecting top quartile performing funds during these years generated a 10.6% higher return compared to median fund performance.

Top quartile returns for a fund of funds have proven to be strong indicators of future success. As shown in Chart 5, 39% of fund of funds managers with a top quartile fund of funds have a top quartile follow-on fund, while only 1 in 10 managers have a follow-on fund ranked in the bottom quartile.

Chart 5: Funds of Funds – Prior and Successor Fund Quartiles[xiv]



Experienced fund of funds managers are adept at track record verification and can also offer other significant expertise and insights regarding fund selection. Fund of funds managers should provide:

- Keen insights and a time-tested, disciplined selection process designed to illuminate the often subtle differences between the top private equity firms, including:
  - which firms add the most value to their portfolio companies.
  - which firms are more disciplined investors vs. which ones might deviate from their investment strategy for a "hot" opportunity.
  - which firms have succession issues or are not properly grooming younger professionals for senior positions in future years.
- Expertise to negotiate investment terms on behalf of LPs.
- Dedicated resources to monitor the progress of the underlying funds.
- An informed and cost-effective ability to liquidate distributions received in the form of stock.
- Timely, comprehensive reporting capabilities.

Lower cost

Private equity investing requires the payment of annual management fees and carried interest (i.e., a share of the profits) to fund managers. Generally speaking, annual management fees are 2% of committed capital and the carried interest (success fee or share of profits) is 20%. Funds of funds managers also charge a fee for their services, albeit a much smaller one. Typical funds of funds have an annual management fee of 0.75-1.25% plus a smaller carried interest of approximately 5%. The management fees at both the fund of funds level and the underlying funds level often will decrease after the investment period is completed (e.g., four to five years).

Funds of funds managers perform a valuable, labor-intensive service, particularly in the early years of a fund as they are selecting the underlying fund managers. Despite this, investors may have difficulty seeing past this second layer of fees and instead choose to make private equity commitments on their

Fund Performance Metrics

There is no standard calculation methodology for investment returns which makes comparing investment performance somewhat complicated. The absence of a standard allows firms to use the methodology that places their investment track record in the best light—a sort of marketing puffery that has become the norm but also makes it difficult to readily compare among managers. A multitude of footnotes are used in most private equity offering materials to explain which methodology was used and what other assumptions were made. For example, footnotes may explain whether poor returns from an abandoned investment strategy have been excluded from calculations or whether only realized returns were used.

The internal rate of return ("IRR") methodology and an investment return multiple are commonly used, but each has its flaws. The investment return multiple is a simple calculation that compares total distributions from a fund to total dollars invested, but it does not take into account the amount of time required for investments to mature. To illustrate this shortcoming, assume two funds each have a 3x investment return multiple. If one firm took four years to generate the 3x return and the other firm took eight years to generate its return, the first firm clearly produced better results—same return but in half the time.

The IRR calculation is meant to address this shortcoming by taking into account the amount of time between cash outlay and cash return, but this method is also imperfect. Mathematically speaking, a complex series of cash inflows and outflows can produce more than one correct IRR. IRR results can also vary dramatically depending on whether the cash flows are arranged chronologically as they actually occurred (sequential method) or are arranged as if all investments were made at the same time (time series method). Fund managers often publicize whichever method produces the higher return for them. As a result, track records should be scrutinized and independently verified using the same methodology for all firms under review.

own. Many of these investors don't realize that (1) a fund of funds is often less expensive than the cost of an in-house private equity program, (2) typical fund of funds fees have a relatively small impact on investment returns and (3) **a good fund of funds manager can pay for itself by earning higher net returns than an internal team might generate.**

As you can see in Chart 6, the annual cost of an in-house private equity investment team can be significant compared to a typical fund of funds manager. Assuming a fund of funds management fee of 1% per year, an investor would have to commit over $36 million per year to private equity in order to internally manage the program more cost effectively. At lower management fees, the amount committed to private equity must be even higher to reach breakeven.

Chart 6: Cost of Internal Team vs. Fund of Funds
(based upon a $10 million commitment)

Annual Expense	In-House Costs[xv]	Fund of Funds Cost[xvi]
Salary for 1.5 analysts	$ 120,000	
Benefits	30,000	
Office/Overhead	25,000	
Support Staff	25,000	
Legal	60,000	$ 2,000
Travel	30,000	3,000
Accounting*	80,000	4,000
Management Fee**		100,000
Total	$ 370,000	$ 109,000

*Including custodial costs
**Assumes a $100 million fund of funds with a 1 percent management fee but no carried interest because the above chart depicts annual costs. A carried interest fee would reduce the difference in costs shown over the life of the fund, but North Sky Capital expects that even as much as a 5% carry would result in the in-house cost being higher than the annualized costs of a fund of funds.

The fees charged by a typical fund of funds should also have a relatively small impact on investment returns. Research done by North Sky Capital suggests that fund of funds fees impact a LP's IRR by an additional .75%-3.7% on top of VC and LBO fees which, in our opinion, can be justified in return for providing diversification, professional manager selection and access to top tier VC and LBO funds. Chart 7 shows a sensitivity analysis on how these fees

Chart 7: Sensitivity Analysis on Management Fees and Carried Interest[1]

Sensitivity Analysis – VC and LBO Fee Impact									
Annual Mgmt Fee		1.5%			2.0%			2.5%	
Carried Interest	20%	25%	30%	20%	25%	30%	20%	25%	30%
Gross IRR				**Net IRR to Fund of Funds**					
20%	14.6%	13.8%	13.0%	**13.5%**	12.8%	11.9%	12.4%	11.6%	10.8%
30%	23.7%	22.7%	21.6%	**22.7%**	21.7%	20.6%	21.6%	20.6%	19.5%
40%	32.9%	31.7%	30.3%	**31.9%**	30.7%	29.3%	30.9%	29.6%	28.2%

Sensitivity Analysis – Fund of Funds Fee Impact									
Annual Mgmt Fee		0.50%			0.75%			1.00%	
Carried Interest	0%	5%	10%	0%	5%	10%	0%	5%	10%
Net IRR to FFs				**Net IRR to Investor**					
13.5%	12.8%	12.2%	11.6%	12.4%	11.8%	11.2%	12.0%	11.4%	10.8%
22.7%	21.9%	21.1%	20.3%	21.5%	**20.7%**	19.9%	21.1%	20.3%	19.5%
31.9%	31.1%	30.1%	29.1%	30.7%	29.7%	28.7%	30.3%	29.3%	28.2%

impact a LP's IRR. The net IRR assumes a 2.0% management fee and 20% carried interest at the VC and LBO fund level. To illustrate, a group of underlying funds with a gross IRR of 30% would yield 22.7% net of fees. The return would be reduced to 20.7%, if a fund of funds manager that charges a 0.75% management fee and 5% carried interest was used to select that group of managers.

Higher return expectations with less risk

As discussed in the preceding pages, the professional selection capabilities and insights of a good fund of funds manager has the strong potential to result in better overall investment selection, and thus better returns, than many investors could achieve on their own. In addition, funds of funds, by design, invest across numerous underlying fund managers. This diversification significantly reduces the risk of catastrophic loss that might result from an investment in a single private equity fund. Given the high minimum investment requirements of many private equity firms, only investors placing a large amount of capital may match the diversification of a typical fund of funds. Of course, a fund of funds also decreases the probability of generating stratospheric returns for similar reasons. There is a strong argument to be made for a diversified investment that historically has generated strong returns to an undiversified investment with equal chances of returning, say, a 100% gain or 100% loss.

CLOSING COMMENTS ABOUT THE CURRENT PRIVATE EQUITY MARKET

We believe there are tremendous investment opportunities in private equity today. It is a cyclical business and the current landscape looks much different than it did three years ago. What follows is a brief commentary on recent industry trends.

Many choices/longer fundraising cycles

The current fundraising market is making it difficult for funds to reach a final close. While the amount of capital being raised is increasing, the number of funds able to reach a final close is decreasing, signaling increasing competition in the market. Dow Jones reports that $64.7 billion was raised by U.S. private equity firms in the first half of 2011, representing a 35% increase relative to the $47.8 billion raised in the first half of 2010. The number of firms able to reach a final close, however, dropped 11% from 225 in the first half of 2010 to 201 in the first half of 2011. This trend was extremely evident in the venture capital world where the amount of capital raised increased 19%, while the number of funds that held closings dropped 38%. This increased competitive fundraising environment is likely to continue throughout 2011 and into 2012.

Favorable exit opportunities are returning

As a result of the financial crisis and recent recession, private equity firms had a difficult time providing profitable exit opportunities to their LPs until recently. The collapse of the equity markets and the lock-up of the credit markets over 2008-2009 hindered profitable exits through usual avenues such as IPOs, trade sales or sales to other GPs. Broader economic conditions have improved and private equity-backed exit activity has returned to levels not seen since the onset of the financial crisis. This rebound is allowing GPs to provide much needed liquidity to their LPs.

[i] Harvard Management Company, October 2010
[ii] Ibbotson Private Equity and Strategic Asset Allocation, October 2007
[iii] Private Equity Council; published in Ibbotson Private Equity and Strategic Asset Allocation, October 2007
[iv] 2010 Harvard Management Company Endowment Report, 2010 Yale Endowment Annual Report, 2010 Princeton University Report from the Treasurer, 2010 Stanford Management Company Report
[v] Preqin Survey of 100 Leading Private Equity LPs
[vi] Cambridge Associates
[vii] The Yale Endowment 2009 Annual Report
[viii] Preqin IPOs Factsheet, February 2011
[ix] CapitalIQ
[x] Preqin Deals Factsheet, July 2011
[xi] Preqin IPOs Factsheet, February 2011
[xii] Cambridge Associates, July 2011
[xiii] Bjoern Born
[xiv] Preqin Special Report; Performance of Private Equity Funds of Funds, April 2011
[xv] Asset Alternatives
[xvi] North Sky Capital Estimates

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