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PRIVATE EQUITY: A BUYER'S GUIDE

Manager selection and strategy are key decisions.

Private equity comes in many flavours, including venture capital, mezzanine, distressed, international and secondary market funds. The most popular variant by distribution of assets is buyouts, representing approximately 50% of all assets. Venture capital gets the next largest allocation, capturing about 20% of the dollars committed to private equity. Over the last 20 years, returns from buyouts and venture have been roughly the same, averaging 16% annually. The U.S. has generally outperformed Europe, and mid-sized funds have done better than larger funds.

The two crucial elements of performance are persistence and dispersion. In private equity, the range from the top performers to the worst is far broader than in publicly traded equity. Over the last five years in North America the spread from the best funds to the worst was 57%. More significantly, there is very strong persistence of returns among managers: good managers consistently do well, and bad managers consistently underperform. The obvious conclusion is that manager selection is far more important in private equity than in public equity.

No discussion of private equity returns would be complete without touching on the "J-curve," or the pattern of returns in a typical private equity investment. For the first couple of years following the initial commitment, a partnership incurs costs while searching for, evaluating and structuring transactions. The returns tend to come later as the investments are realized or liquidated. When presented graphically, the pattern of losses in the early years followed by returns takes the shape of the letter "J".

Investors can participate in private equity through several different approaches, each with its own merits and considerations: by building a direct investment team; investing in funds; investing in funds of funds, or; co-investing with a general partner. Costs vary with each strategy: for direct investments costs are expenses and salaries, while for funds it is normally a management fee of 2% and a carry of 20%. Funds of funds add another 1% and 10% on top of the underlying 2% and 20%, and co-investment costs are variable. The table above offers a comparison of the strengths and weaknesses of each approach.

COMPARISON OF PRIVATE EQUITY STRATEGIES—ADVANTAGES AND DISADVANTAGES

Advantages	Disadvantages
DIRECT	
May be lower cost	Need large fund to be viable
Full discretion	Difficult to recruit staff
Greatest transparency	Staff retention a risk
Most control	Building a team is challenging, long-term proposition
FUND	
Limited in-house staff requirement	Control shared with other LPs
Can have multiple managers and investment types	Less control over timing of investment, cash calls, realizations
Less onerous due diligence required	
Global in outlook	
Opportunistic	
FUND OF FUNDS	
Easy international diversification	Highest cost and carry
Access to household name brands	Can be coalition of the mediocre
Least amount of in-house resources required	No control or influence
Lowest due diligence requirement	Limited transparency
Immediate diversification by manager, type and style	

In summary, private equity is truly a long-term asset class. It has the potential for superior returns, and has a place in just about every portfolio. It should be viewed as an extension of the public equity portfolio, offering lower volatility and enhanced diversification as well as the higher return potential. Manager selection is more important than in public markets and manager skill is more important than in public markets. Careful selection should lead to highly satisfying outcomes. ■