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## **Private Equity - A Must In Well-managed Investment Portfolios**

By: Tom Kennedy & Humberto Aquino

Some very large and successful transactions recently completed by private equity firms have once again put the spotlight on this asset class as sophisticated institutional **investors** are increasingly finding that private equity **investing** fits within their long-term return requirements.

Private equity, sometimes called the purest form of capitalism, refers to **investing** in companies that are not listed on the public markets. The vast majority of businesses within the overall economy are privately held, and the private equity market has grown up as the preferred capital market for most of these companies who, for their own reasons, prefer to stay out of the public markets. The managers of private equity funds typically take an active role in the management of their portfolio companies, to execute on an **investment** thesis designed to add significant value to the business over a three to five year time horizon. At the large cap end of the private equity market, these fund managers have acquired publicly traded companies and taken them private to execute on a new strategy or restructure operations outside of the public spotlight.

While it may appear to be an overnight success, private equity **investing** has, in fact, existed for at least a couple of hundred years – long before the inception of the public stock markets. Today's focus, and the perception that it represents a new asset class, is based on the dramatic expansion of the buyout market. What is truly new is the emergence of a more formal, disciplined, and professional private equity market that allows **investors** to tailor their portfolios.

These developments, along with very strong performance experience, are the primary attractions of private equity today.

As for performance, the shared view among portfolio managers is that holding a diversified portfolio of select publicly traded stocks for the long-term will likely yield a single-digit net return. Private equity, on the other hand, has historically delivered risk adjusted double-digit returns, typically delivering an incremental 500 to 1,000 basis points over the public markets, or net returns to the investor in the range of 15 per cent to 20 per cent.

### **No Superior Return Guarantees**

In the investment business there are never guarantees – returns in the past don't guarantee results in the future. If there were, there would be no premium paid for taking and managing risk.

Private equity investment requires highly specialized skills and it is very important to identify the best available opportunities, with a fund manager that has a demonstrated track record of success. Part of the skill set is managing risk in the context of an illiquid investment portfolio. Financial sophistication is also very important, with leverage representing one of the important drivers of financial returns. But the key to selecting a fund manager is really their business operating experience – their ability to develop and execute on an investment thesis that can double or triple the value of the business over the life of the investment.

In private equity, the overall portfolio risk is managed through selection of the most experienced and proven fund managers. A private equity fund-of-funds represents a very effective way to manage this risk across a broader portfolio, using the experience and resources of a fund-of-funds manager to construct the most effective portfolio available.

In spite of the strong performance, private equity is still relatively under-utilized by Canadian pension fund managers. In the United States, a typical pension fund today has a private equity allocation in the range of five per cent to 10 per cent of its total assets, while in Canada, most mid-size pension funds still manage predominantly public market portfolios with no (or only very small) commitments to other asset classes. Some of the most successful endowment funds in the United States, have much higher allocations. One of the best known is the Yale University Endowment Fund which has allocated as much as 25 per cent of its assets to private equity in the past.

### **What Is The Right Allocation?**

With the strong return experience of private equity, some may suggest that a wise investment course would be to invest exclusively in private equity – which some very wealthy individuals do. But institutional investors have different portfolio requirements, and typically manage risk by diversifying among different asset classes.

In general, most pension managers will look to match a portion of their portfolio to service obligations that are 10, 15, or 20 years down the road. For these managers, an investment in private equity is a part of their diversification strategy.

For Canadian pension funds, now is an excellent time to take a serious look at private equity. In fact, we believe that two or three years from now, most Canadian pension funds, endowment funds, and high net worth individuals will have between five per cent and 15 per cent of their portfolio allocated to private equity. ■

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