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Private Equity: Access for Smaller Investors

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It's no secret that private equity allocation has become a standard component in many institutional **investment** portfolios and Canadian funds have participated in the growth of this asset class. In 2006, Canadian funds took in more than \$9 billion, or three times the amount raised in 2005.¹

Private equity emerged as a major force in corporate finance, as buyout funds took many large companies private, including several well-known Canadian firms such as Intrust Corp. and Fairmont Hotels and Resorts, Inc. And this 'alternative' asset class is poised to continue its momentum into 2007. A recent global survey² of private equity limited partners found that 44 per cent of **investors** plan to increase their private equity allocations, up from 30 per cent six months earlier. There's a reason for the increasing institutional interest in private equity funds – a history of above-average returns, particularly over the long term. Thomson Venture Economics reported that its All Private Equity Index returns over the 10- and 20-year periods outperformed the S&P 500 by 7.5 per cent and 2.7 per cent, respectively, as of December 31, 2005.

Generated Skepticism

Private equity's rapid growth has generated skepticism as to whether the asset class will continue to perform. Yet, for all the recent activity, the potential universe of companies worthy of investment remains largely untapped. There are more than 100,000 private companies in the United States versus only roughly 10,000 to 12,000 public companies and the universe of attractive private equity targets expands even further when general partners look beyond U.S. borders.

However, private equity creates its share of challenges for plan sponsors. Investors must commit to a fund for the long-term and should not expect to see any positive cash flow for at least five to seven years. And while the private equity market has enjoyed successful returns for years, individual deals can generate high levels of risk and volatility.

This competition may place smaller and mid-sized plan sponsors at a disadvantage. But these institutions can address the challenges of risk and limited access by investing in a private equity fund of funds. As the name implies, a fund of funds allocates the capital provided by a number of investors into a select group of private equity funds. By pooling capital, a fund of funds lets smaller investors overcome the high minimums charged by the larger funds that often have the best track record over a long period.

At the same time, smaller investors gain access to the same manager talent and priority deal flow offered by larger private equity funds. The fund of funds manager takes on the responsibility for combing through numerous offerings and performing exhaustive due diligence on funds. Reference calls, analytical verification of a manager's track record, and site visits all form part of this review process.

Fund of funds managers offer one additional service to help small institutions minimize investment costs. By consolidating the reporting from all of the underlying fund managers, including the thankless task of preparing consolidated tax reporting for investors, a fund of funds can effectively outsource the management of a private equity allocation.

Despite private equity's surge in popularity, the process of finding and investing in high-quality, undervalued companies remains relatively inefficient, creating strong return opportunities for skilled managers. The top quartile of private equity programs demonstrated a return roughly double that of the top quartile mark of the U.S. equity program through the third quarter. The opportunity is there, and the key to successful private equity investing is in finding those skilled managers and tempering the risks that come with a potentially volatile asset class.

1. Private Equity Intelligence (UK firm) quoted in National Post 1/6/07

2. Global Private Equity Barometer, Winter 2006

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