

## Overview

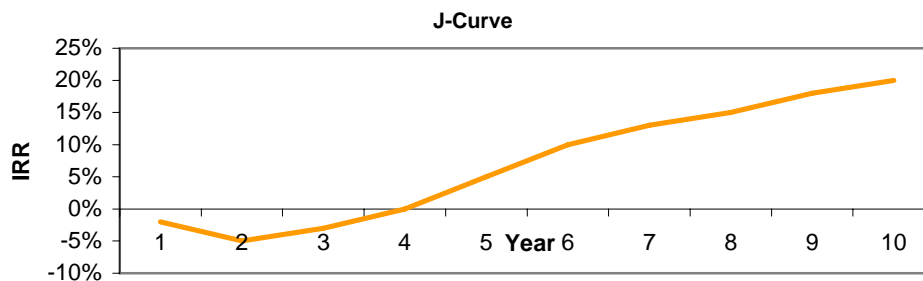
Private equity broadly refers to investments in privately held companies, which represents approximately 97% of companies in the US with over \$10 million in annual revenues according to Dun and Bradstreet. These investments are usually made as equity but may also include debt structures. There is no public market to trade these private interests. Private investments may be made at any point in a company's lifecycle from formation through maturity and, in some cases, during distress or restructuring. We simplify these strategies into three categories: venture capital, buyout, and opportunistic (including private debt, secondary purchases, and other strategies). Venture capitalists typically invest in newly formed entities with little or no revenue or earnings. They will often build a management team, provide technical expertise, and develop strategic plans to grow the firm. Buyout managers typically invest in more established companies. The managers may take a control (buyout) or non-control (growth equity) position and often will develop or change management, improve operations, or merge with another other firm to make the firm more profitable. Profits from a private equity investment are realized through a public offering of shares, a recapitalization, merger, or sale to another firm.

## Characteristics

Institutions typically invest in private equity through limited partnerships managed by investment managers. Some of these managers are registered with the SEC although most are not. Investors commit capital to a partnership (a "blind-pool") and the investment manager then seeks investment opportunities. As investments are made, the manager makes "capital calls" for the needed portion of the commitment. New investments are made for a set number of years (the "investment period"), typically five, after which positions are sold. Capital is returned via a distribution as investments are sold. The life of a partnership is typically 10 years but may be extended to accommodate a full liquidation.

The private markets are less efficient, have fewer participants, are less liquid, and disclose less information than public markets. Critical success factors for a private equity manager include sourcing quality deals, conducting appropriate due diligence, investing the right amount of capital at the right price, implementing a plan that adds value to the portfolio company, and pursuing the appropriate exit strategy (sale or public offering). These characteristics make private equity investing a more expensive endeavor, but can be used to produce returns higher than the public market.

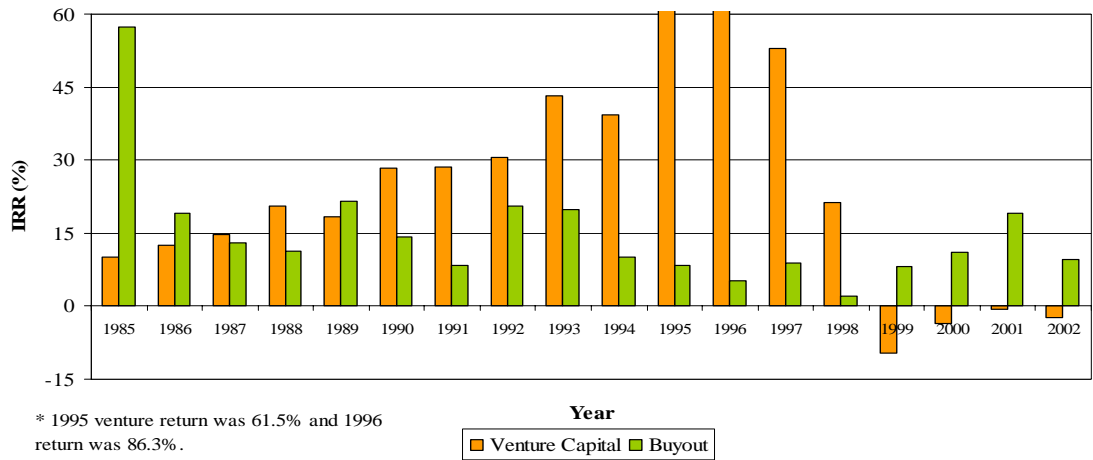
Over the life of a partnership, its reported value often follows a "J-curve." With limited capital invested in the first few years and most investments held at cost, operating expenses overwhelm income and gains. As a result, the partnership valuation reflects losses. As investments mature, the partnership valuation accelerates creating a J-shaped curve of returns over time.



Private market investment performance will vary depending on the vintage year. The market environment can change dramatically from year to year. As a result, private equity managers are often compared to the other funds that were raised in the same year (the vintage year). Although results for periods shorter than a full investment cycle (10 years) are reported, short-term returns can be misleading. Differences in valuation policies and timing of exits can materially impact interim performance. The performance of the 1999-2000 vintage year funds, while not complete, is not likely to perform as well as funds from previous years.

**Private Equity Vintage Year Returns**

As of 12/31/05



**Why Invest in Private Equity**

Private equity has the potential for high long-term returns due to the inefficient and illiquid nature of this segment of the market.

Performance Through 12/31/05

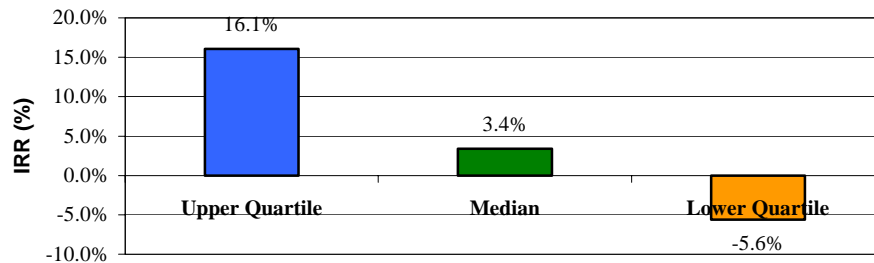
<u>Fund Type</u>	<u>1-Year</u>	<u>3-Year</u>	<u>5-Year</u>	<u>10-Year</u>	<u>20-Year</u>
All Venture	14.1%	7.7%	-6.7%	23.7%	16.5%
All Buyouts	28.9%	16.7%	5.4%	9.4%	13.4%
<b>All Private Equity</b>	<b>21.4%</b>	<b>13.5%</b>	<b>1.6%</b>	<b>12.4%</b>	<b>14.3%</b>
<b>S&amp;P 500</b>	<b>4.9%</b>	<b>14.4%</b>	<b>0.5%</b>	<b>9.1%</b>	<b>11.9%</b>

Source: Venture Economics; pooled returns

Over most time periods, the average returns from the private markets, as measured by the pooled returns of all managers in the Venture Economics database, have historically provided a premium to the public market. Also of note is the counter-cyclical nature of venture and buyout investments. Market dynamics have favored buyouts over the last one-, three-, & five-year periods while venture has outperformed over the last 10- and 20-year time periods. This counter-cyclical pattern repeats historically.

Manager selection is critical in private equity as the returns of private equity managers are widely dispersed. Unlike public fund managers, studies have demonstrated persistence of top quartile private equity managers. Reasons for this persistence include access to proprietary data, sourcing, and skill.

Venture Economics: All Private Equity Performance  
Vintage Year 1990-2002



### FEG Approach to Private Equity Investing

Keys to successfully implementing a private equity allocation are managing the risks:

1. **Vintage Year Diversification** - Clients should invest at a measured pace across vintage years. A consistent pace will reduce the likelihood of missing a strong vintage year or investing too much during years when the private equity market is more challenging.
2. **Strategy Diversification** - Clients should invest with both venture and buyout managers, and opportunistically in distressed or other unique strategies. This diversification will reduce the volatility of the returns and ensure that they don't miss a cycle of strong returns in one sector.
3. **Top Performing Managers** - While the average return for all private funds has outpaced the public markets by between 200 and 300 basis points, the dispersion of returns between median and upper quartile private funds is consistently over 1000 basis points. Private equity investing is most compelling when the portfolio outpaces the averages.

FEG works with clients to construct portfolios with vintage year diversification, strategy diversification and access to those investment managers identified as most likely to provide strong future returns. Our internally developed implementation models generate annual commitment targets to build and manage a portfolio with vintage year diversification. By strategy, we work to build portfolios across three categories: venture capital, buyouts and special situations. We target between 25% and 33% each to venture and opportunistic strategies and between 33% and 50% to buyouts. Opportunistic strategies include secondary managers, distressed, mezzanine, emerging markets and other.

Private equity investing can be implemented through direct funds, fund of funds, or combination of the two. Very large and experienced investors may also seek co-investment opportunities with fund managers. A fund of funds structure offers diversification by vintage year and by manager by investing in ten to fifty or more funds. The best vehicles provide access to top-quartile managers that are closed to new investors. Fund of funds management fees are typically between 0.50% and 1.50% of capital commitments. Some firms also charge a carried interest of between 3% and 10% of profits. Most institutional firms either charge 1% or less without a carried interest feature, or offer a management fee on the low end of the range along with a modest carried interest.

Building a portfolio of direct private equity funds saves an extra layer of fees but requires an investor to spend additional time and resources for manager selection, oversight, and client

involvement. Direct funds can be used to build a complete private equity portfolio or can be used to complement fund of funds.

Private equity funds typically raise capital once every few years. The vehicles used should be determined by the time commitment of the investor and the amount of capital available to be committed over this three-year cycle. Generally, FEG would recommend that smaller private equity portfolios use only fund of funds while large portfolios use direct funds or a combination of both. The following table gives a guideline for an appropriate strategy:

Private Equity Portfolio Size	Private Equity Investment Vehicle(s)	Total Number Of Private Equity Funds	Client Involvement
Small	Fund of Funds (100%)	20-60	Low
Medium	Fund of Funds (20%-40%)	30-70	Medium
	Direct Funds (60%-80%)		
Large	Direct Funds (100%)	15 +	High

**Conclusion**

Allocating capital to private equity should provide a return enhancement to the client’s portfolio. A properly constructed private equity portfolio will manage the key risks by diversifying across vintage years and strategies while focusing on the top-performing managers. The top-performing managers are those who take advantage of the illiquidity, lack of public information available on underlying companies, and business and technology risk associated with new companies. The potential returns for clients who accept these risks make private equity investing compelling.

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