Fiduciary Trust International

Introduction to Private Equity Investing

Private equity is an alternative asset class and an illiquid investment that is best suited for investors with a long-time horizon. Private equity encompasses a broad range of underlying strategies across company life cycles (early stage to mature) and capital structures (equity and debt). Investments are primarily made in non-public companies with the intention to influence or control their strategic growth, profitability, governance, capital structure, and/or undertake other value-creation levers.

Investors generally use private equity within a multi-asset class portfolio to gain exposure to select higher capital appreciation opportunities than what are typically available within public equities. A diverse portfolio of private equity investments may enhance an investor's risk-return profile, providing potential incremental return and greater diversification.

How Public and Private Equity Differ

Public and private investment opportunities feature important differences, in terms of both structure as well as risk and return drivers. Public equities, for example, are traded in a highly efficient and regulated market environment, which allows for transparent pricing and high liquidity.

Private equity investments are structured either via private partnership vehicles, typically limited partnerships (LPs), or direct investments in companies and face varied regulation dependent on the specific investment vehicle. Investors in private equity typically receive quarterly, but sometimes less frequent, valuations of their investments. Valuations of private equity typically are based on an array of factors, such as comparable public companies and discounted cash flow models. These metrics are subject to the private equity manager's judgment and the nuances of the specific strategy.

While secondary markets do exist, private equity cannot be easily liquidated by an investor and should be considered a long-term investment without ability for early redemption.

Private Equity Return Drivers	Private Equity Key Risks
Control/Influence	Illiquidity
Aligned Incentives	Execution
Leverage	Low Transparency
Long-Term Horizon	Fees
Concentration	Unsystematic

By taking on illiquidity, private equity investors benefit from several unique return drivers due to the non-publicly traded aspect and privately negotiated nature of the investments.

While public equity investors are passive shareholders, the ownership structure of private equity results in greater investor control or influence. Private equity investors can be active operators and take a long-term view to create value, without being subject to short-term milestones such as earnings announcements. The long-term view of private equity also helps to align incentives between private equity managers and investors in their funds.

Opportunity and Risk

The higher return potential of private equity comes with increased risks as compared to public markets. These risks include illiquidity, lack of transparency, concentration, high fees, and general complexity of execution.

Reduced transparency arises from limited underlying company financials, multiple approaches to fund- and company-level valuations, and generally lower and less frequent availability of information. Private equity managers use this opacity and market inefficiency to find and unlock value via sourcing, making add-on acquisitions, and/or selling companies.

Concentration similarly is both a risk and return driver. Funds may invest in a small number of underlying companies, increasing the reward or risk derived from any one company's performance. This is especially true as private equity is subject to unsystematic risks, which are company specific risks unaffected by broad market movements and conditions. Investors should also be aware that the complexity of private equity comes with unique tax structures. On occasion, this complexity may lead to delays in distributing important tax information, such as K-1s.

For these reasons, investors should seek out the advice and ongoing oversight of trusted financial advisors before making any long-term private equity commitments. For most private equity funds, investors must meet the criteria of both an Accredited Investor and a Qualified Purchaser (QP). While there are nuances to consider, a QP is usually the stricter of the two hurdles. A QP is either an individual with $5 million or more in investable assets or an institution with $25 million or more of investable assets.

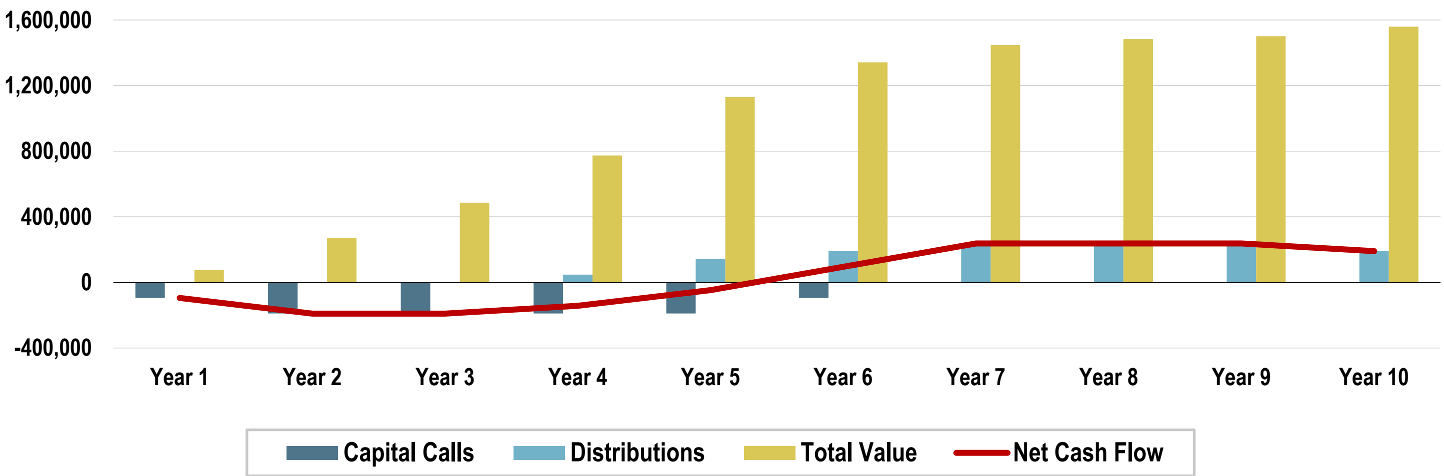
Access and Structure

The most common way to access private equity is through private equity funds. Private equity managers typically raise funds every three to five years for a particular strategy. The year in which a private equity fund is formed is referred to as its "vintage." Investors must commit to the fund during the fundraising period, although all capital committed will not be immediately invested. Rather, investments are made over time during the investment period as underlying opportunities are identified by the manager.

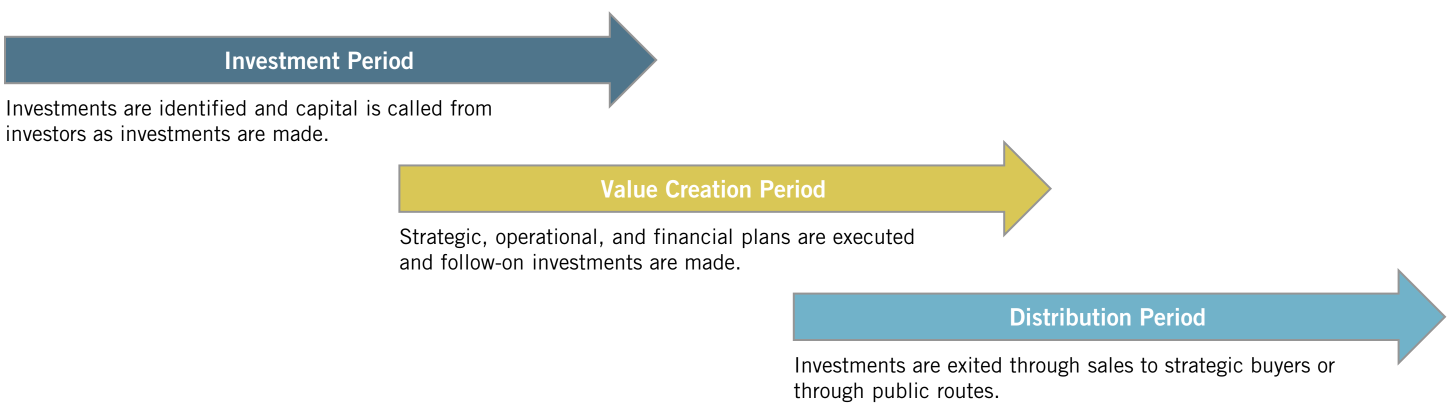
For example, a 2022 vintage fund will invest capital any time from 2022 through 2026 and beyond. This means investors are making an investment decision in advance of when their capital will be allocated to specific deals or companies, and well in advance of when those investments will be exited or realized.

During the early period of a fund's life, as capital drawn down, investors often receive initial performance statements that indicate a loss. This occurs as part of a valuation "J-curve" in which the fee component of the investment (typically 2% of total commitments), will initially outweigh the small percentage of capital actually invested and "called" from investors. As more capital is drawn and underlying investments appreciate, valuations begin to rise above underlying costs.

Private Equity Fund Cycle



Source: Fiduciary Trust International. **For Illustrative purposes only.**
As of March 31, 2021.



Once a fundraising period closes, a private equity fund is closed for the rest of its term. This period ranges from 8 to 12 years on average, usually with potential extensions periods. Investors cannot redeem during this period and must wait for underlying investments to be sold or otherwise exited by the private equity manager to realize gains. Investment exits typically occur within three to five years after each underlying investment is made but can be shorter or longer depending on the strategy and the market environment.

Underlying Strategies

Private equity managers invest across company stages and economic cycles. This includes investments in early-stage or mature companies as well as in stressed or distressed companies and everything in between. Investments may be made across the capital structure of companies, both equity and debt.

The four main stages of private equity and their respective value-increasing actions generally correspond to the various stages of a company's lifecycle:

1. Venture Capital = Company Formation / Infancy Stage
2. Growth Equity = Rapid Growth Stage
3. Buyout = Mature Stage
4. Distressed = Restructuring / Revival Stage

Venture Capital. Venture capital consists of investing in early-stage, high growth-oriented innovative companies, often referred to as start-ups. The primary source of returns is for the successful and profitable introduction of the company's products or services to the market. To reach that point, these companies often need to prove out their technology and/or move through regulatory milestones, both of which bring increased risk. But with the increased risk also comes the highest return potential across private equity strategies.

Growth Equity. Growth equity seeks to invest in proven yet not fully mature companies often at an inflection point and/or undergoing a transformational event in their lifecycles, with potential for some dramatic growth. Capital is generally used to subsidize expansion of operations, new market entry, and provides the means to acquire complementary companies to boost the parent company's revenues and profitability. Growth equity investments generally come with a shorter holding period (on average, 3-7 years) compared to venture capital investments (average 5-10 years).

Buyout. Buyouts are the most popular form of private equity. Capital is used to acquire controlling ownership interest in target companies, along with non-control investments, recapitalizations, and refinancing transactions. The target companies are mature and no longer growing quickly but enjoy higher margins and substantial cash flows. This allows for a higher degree of leverage to be used in the transactions ("leveraged buyouts"). Investor returns may be driven by operational improvements such as restructuring, cost-cutting, or price increases. Profitability is also unlocked via "buy & build" add-ons, roll-ups, and various other measures.

Distressed. Mature companies on occasion struggle due to changing market dynamics, new competition, technological changes, poor capital structure or over-expansion. If the company's troubles are serious enough, a private equity manager specializing in stressed or distressed investing may invest in the company's debt securities. In some cases, the manager will attempt to influence or control a turnaround and/or a restructuring.

Long-Term Performance

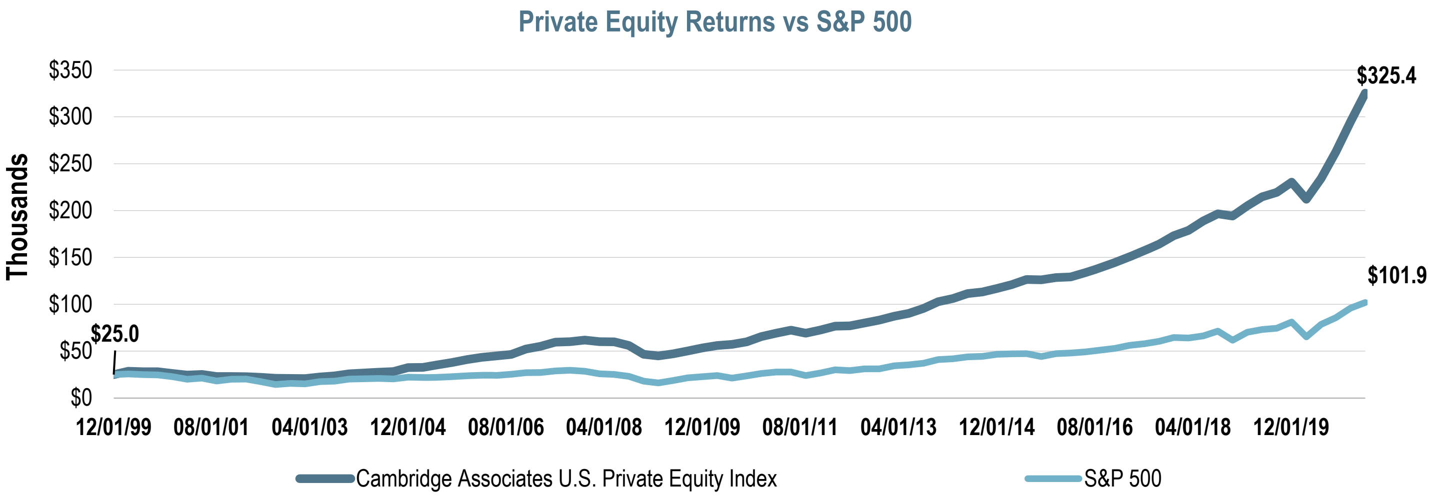
Private equity's appeal is its potential for higher returns when compared to public equities. Over long time periods, private equity has outperformed relative to public equities. The average historical spread between private equity and public equities is approximately 300 to 400 basis points, or 3% to 4%, but can vary widely depending on the time period, the methodology, and the private and public equity indices used.[1]

Although the dominant exposure is equity or equity-like, private equity and public equity are not perfectly correlated.

1. The average difference between Internal Rate of Returns for private equity using the Hamilton Lane benchmark and the MSCI ACWI Direct Alpha Public Market Equivalent for vintage years from 2006 through 2020 as of March 31, 2021 is 430 basis points.

Private Equity Outperforms Across the Business Cycle

When added to a portfolio, private equity may enhance an investor's risk-return profile and diversification over the long term.



Growth of $25,000 starting investment beginning on Jan 1 2000. Cambridge Associates U.S. Private Equity Index uses quarterly horizon pooled returns from Jan 1 2000 through Mar 31 2021. S&P 500 using quarterly total returns from Jan 1 2000 through Mar 31 2021.
Source: Cambridge Associates; FactSet. Important data provider notices and terms available www.franklintempletondatasources.com.
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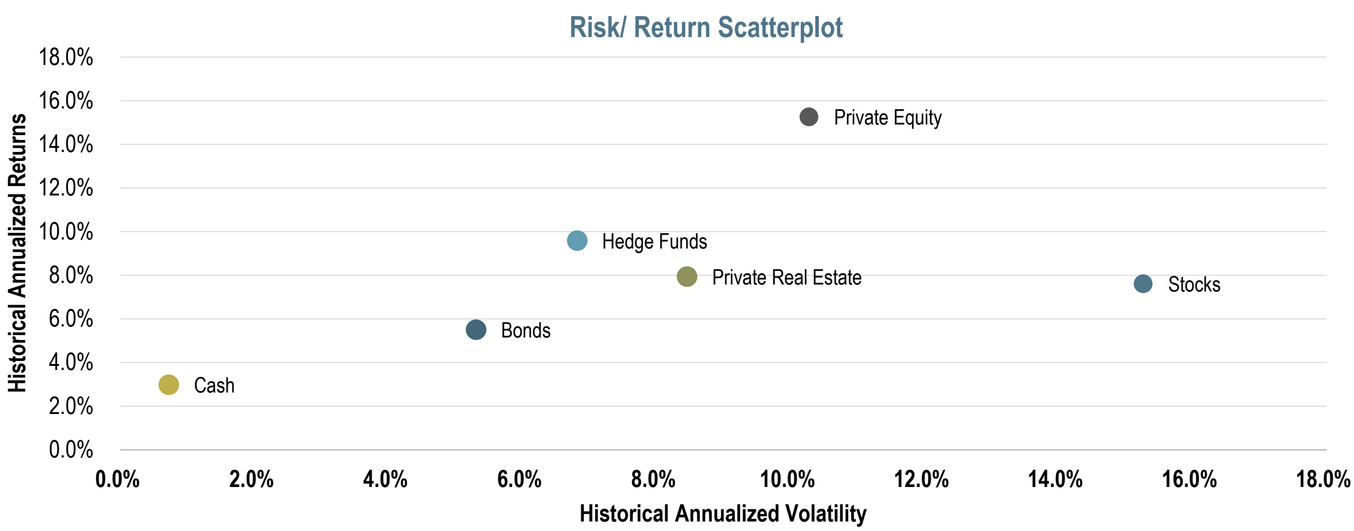


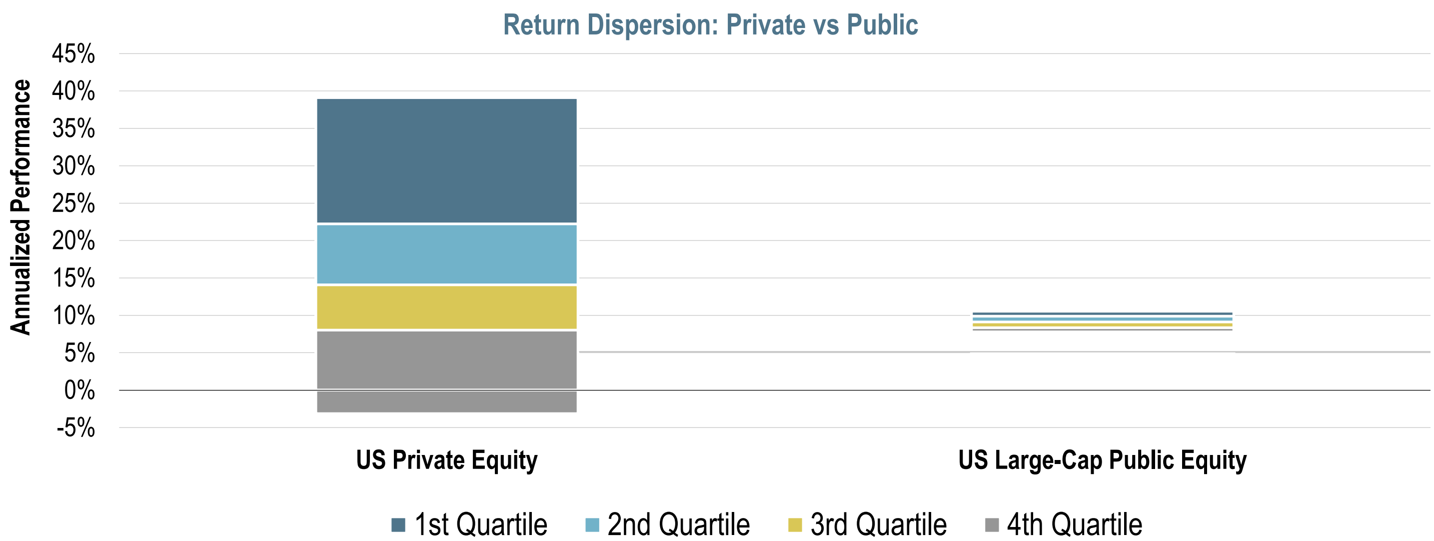
All return and volatility measurements use data from Jan 1 1990 through Mar 31 2021. Stocks, Bonds, Hedge Funds, and Cash use monthly Total Return in Risk/Return calculations. Private Equity and Private Real Estate use Quarterly Pooled Horizon Returns in Risk/Return calculations.

Stocks	MSCI ACWI Total Return
Bonds	Barlcays Global Agg Total Return
Hedge Funds	HFRI Fund Weighted Composite
Cash	Barclays US T-Bills 3-6 months Total Return
Private Equity	Cambridge Associates Global Private Equity Index
Private Real Estate	Cambridge Associates Global Private Real Estate Index

Source: Cambridge Associates.
As of March 31, 2021.

Return Dispersion: Private vs Public

Within private equity, the dispersion from top to median performers illustrates the real attraction of the asset class compared to public markets. While public equity funds display a tight range of performance between top and bottom performers, the performance of private equity funds fall across a wide spectrum of outcomes. The most compelling risk-adjusted returns relative to public equity have been in the top quartiles of private equity funds. This difference from the median is often measured in hundreds and, in some vintage years, thousands of basis points. As such, the importance of strong manager due diligence and selection is key when building a private equity portfolio.



Performance dispersion separated into quartiles based on horizon annualized total returns (public equity) and annualized pooled IRRs (private equity) from Jan 1996 through Mar 2021. Max and Min values over the horizon are limited to the 95th percentile (max) and 5th percentile (min) to remove affects of extreme outliers.
US Public Data source: Lipper US Large Cap Core Equity Universe; Annualized Net Total Return.
US Private Equity source: Cambridge Associates U.S. Private Equity Index; Annualized Net IRR, Vintage years 1996 - 2021.
Source: Cambridge Associates; FactSet. Important data provider notices and terms available www.franklintempletondatasources.com.
As of March 31, 2021.

Diligence and Diversification

In building a portfolio of multiple private equity investments it is important to balance the goals of:

- Diversification across strategy and vintage year and,
- Investing in the highest quality, alpha generating managers.

Each investment should contribute to the diversification of an investor's portfolio whether by vintage, strategy, geography sector, or another differentiating factor. Following a steady allocation pace across both private equity vintage year and strategy adds critical diversification, both within the asset class and in the context of the broader portfolio.

This approach is designed to capture all the drivers of returns for particular time periods.

Periodic Table of Returns: IRR by Vintage Year & Strategy

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
25.2%	13.0%	12.2%	10.3%	16.1%	14.7%	16.3%	27.3%	25.3%	24.0%	24.8%	27.2%	27.1%	33.3%	36.4%	54.1%
16.5%	11.3%	8.5%	9.4%	14.5%	14.6%	15.3%	15.9%	17.8%	17.6%	19.2%	22.4%	27.0%	30.3%	35.7%	39.6%
16.5%	10.9%	8.0%	8.3%	11.3%	12.8%	15.2%	14.2%	15.2%	15.7%	16.4%	20.2%	19.4%	24.5%	34.4%	31.3%
10.0%	8.7%	8.0%	8.1%	10.1%	11.8%	14.6%	13.7%	15.1%	12.1%	14.3%	19.5%	17.7%	22.8%	28.0%	29.3%
8.8%	7.9%	6.6%	7.7%	9.6%	9.7%	8.6%	11.9%	14.4%	11.8%	11.3%	14.5%	13.6%	18.1%	19.3%	28.0%
N/A	6.6%	5.9%	6.1%	9.2%	6.9%	8.4%	4.4%	8.3%	11.3%	5.1%	10.8%	9.9%	9.8%	10.9%	24.9%

Buyout | Growth Equity | Venture Capital | Control-Oriented Distressed | Subordinated Capital | Secondary Funds

Source Data: Cambridge Associates as of December 31, 2020; Chart Created by Fiduciary Trust International.

Of equal or greater importance to diversification is due diligence. Identifying and selecting high-quality managers who have a rigorous and repeatable investment process is critical to a successful private equity portfolio. A successful manager's process usually includes sourcing potential investments, selecting the most compelling ones, structuring and negotiating a transaction, creating operational and financial value, and finding exit routes to maximize the ultimate return. It's designed to reward investors who have a long-term horizon embedded in their overall asset allocation plan and take a consistent, disciplined approach.

Investors should cast a wide net when sourcing potential private equity funds and have a disciplined process to focus on those that meet defined criteria. An institutional due diligence process typically occurs in stages and, depending on the complexity of the strategy and/or the background of the manager, can be time intensive. In brief, the process includes multiple manager meetings/calls, review of manager and strategy materials, research on the specific opportunity set and landscape of peers, detailed performance and attribution analysis, reference interviews, and operational and legal review.

Key focus areas of diligence are:

- Team: Individual experience/skills, diversity, group dynamics, resources, ownership, and alignment to investor interests.
- Process: Investment and decision process, execution of strategy, risk management.
- Performance: Statistical / attribution analysis and comparison to benchmarks and peers.
- Edge: Alpha generation, unique skill set, and unique sourcing.
- Terms: fees, structure, and liquidity versus return potential.

A Long-Term View and Disciplined Approach Are Key

Investing in private equity takes time. Years of research have shown that buy-and-hold investment strategies consistently outperform market timing across all market cycles. A similar strategy is critical to success in private equity investing. A commitment strategy that allows an investor to consistently achieve and maintain a targeted private equity exposure can be just as important as determining the initial allocation.

The key is maintaining a steady allocation pace across vintages and strategies. This discipline adds diversification within private equity allocations as well as an investor's broader portfolio. Given that each private equity fund typically runs its course over 10-plus years, making commitments across various strategies can capture multiple return drivers over time.

Fiduciary Trust International has been recommending alternative assets in client portfolios for nearly 30 years. We have long believed in the benefits that alternative investments can bring to a properly allocated portfolio regarding diversification, alpha-generation, and ability to achieve attractive long-term risk adjusted returns through various market cycles.

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