NEPC MARKET CHATTER

To PE or not to PE…That is the Question

More investors are turning to private equity to help achieve their target returns as many markets are fully valued and the expectations for future returns are lower. Will higher allocations to private equity be the "secret sauce" to solve this dilemma given more money is going into private equity, valuations are higher and there are fewer exit opportunities? We continue to believe in the private equity asset class, but recommend caution and patience. We have provided our thoughts on private equity and suggestions on how to navigate the space over the next few years.

Current Status of the Private Equity Markets

Since markets troughed back in 2009, private equity funds have had a pretty nice run. U.S. Buyout Funds that closed between 2009 and 2012 have averaged a 12.0% IRR net of fees through the first quarter of 2016. The venture capital space has performed even better producing a 21.6% net IRR over the same time period. Venture-backed companies are staying private longer and elevated valuations have produced numerous unicorns (companies with greater than $1 billion in value) even though these companies have yet to produce a profit.

These strong returns and the ability of some funds to generate significant alpha relative to peers (Chart 1) have enticed investors to increase their allocation to private investments to help hit target returns in a prospective low return environment. Fundraising has increased in recent years (Chart 2) and the top private equity firms are closing faster than ever with many "one and done closes" given the dispersion in returns between top and bottom quartile managers (Chart 1).

On the venture capital side, a number of highly touted unicorns are starting to see valuations decrease as their potential to monetize the business fails to match early investor projections. Exits are becoming trickier with public equity markets remaining relatively flat since the end of 2014, making IPOs less lucrative and public companies less likely to pursue acquisitions.

Chart 1: Private Equity Internal Rate of Return by Vintage Year . Returns after 2013 not meaningful. Data as of 1Q2016

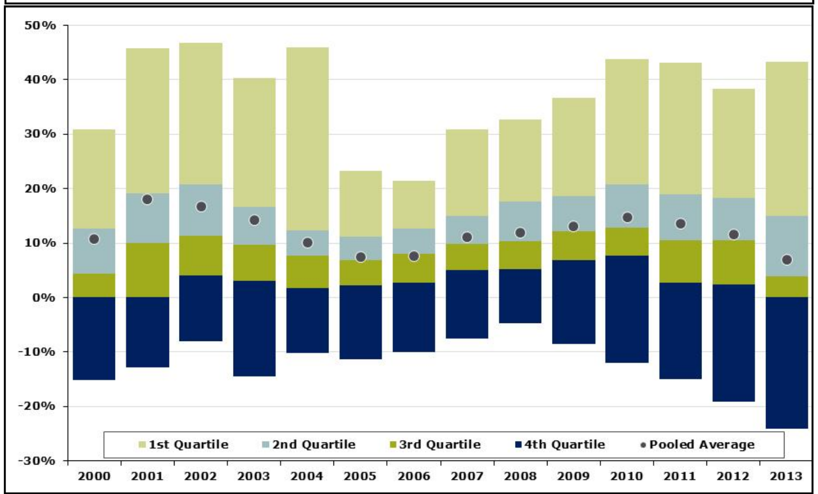
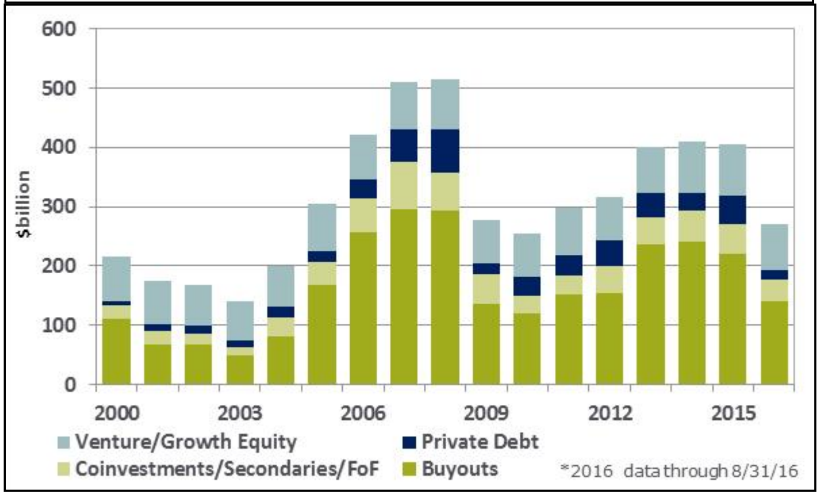


Chart 2: Private Equity Fundraising by Vintage Year. Note: 2016 data through 8/31/16

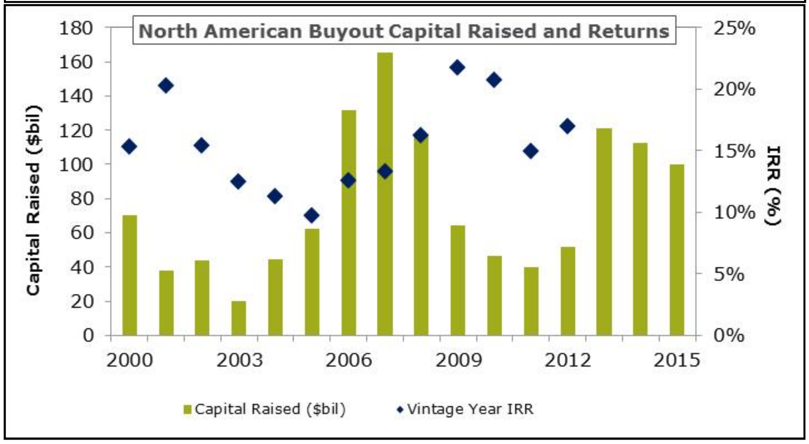


Source: Prequin and Cambridge Associates

Cyclicality of Private Markets

In spite of these difficult markets, we still have a sense of cautious optimism surrounding the Private Equity Markets. Managers continue to find ways to differentiate themselves from their peers in areas such as deal sourcing and value creation in the current high priced, competitive deal-making environment. However, it is important to note that investments will be made in differing market conditions given the four to five year investment periods of most funds. As Chart 3 shows, the average fund return for each vintage year is fairly strong; however, we notice a few trends. First, as the amount of capital raised increases, it appears that performance generally contracts. Second, challenged performance generally occurs two-to-three years before a market pull back. For example, as fundraising levels escalated from 2005 to 2007 the returns are lower than when capital was scarcer from 2008 through 2012.

Chart 3: North American Buyout Capital Raised and Returns



Note: Returns on Buyout Funds after 2012 are not reported due to incomplete data
Source: Prequin (fundraising), Cambridge Associates (IRR)

It is no secret that we expect lower returns going forward across most markets; a market rally doesn't necessarily die due to old age, but could a recession occur in the next three or four years? No one can predict this with any accuracy, but as we make private market recommendations, we are thinking about a variety of economic scenarios and working to identify funds that will perform well in various market environments.

What's the Answer?

We continue to like private equity and it remains an asset class with one of our highest expected returns over the next five to seven years. However, our expected return for private equity is lower than long term history for many of the reasons outlined in this Market Chatter.

So, given all of the above, what's our advice to investors in private markets? Three things: (1) pay careful attention to annual commitment pacing; (2) identify funds that are price conscious and careful in putting money to work; and (3) be patient and opportunistic in finding the best managers to meet your goals.

We believe investors will need to be flexible in implementing the private equity strategic plan to build a program that is diversified across vintage years and strategies. Take a top-down perspective to identify strategies that may perform better in the future market environment. Don't force yourself to fill the annual commitment amounts if you can't identify attractive investment opportunities – patience is important! Given the higher valuation in private markets, investors need to identify managers who have shown historical valuation discipline, a differentiated sourcing angle, and operational expertise and patience (a familiar word by now) in putting capital to work. Investors may need to work a little harder to identify what they believe are the best investment opportunities and then access these funds. Express interest with limited capacity funds long before the fundraising begins to potentially gain access. Investors need to identify the next generation of potential top performers by looking at a "Fund I" which may be a spin-off from a successful private equity firm.

In conclusion, the answer to the question is **"to be in PE"**. Remain disciplined, but flexible in implementing your strategic plan and identifying potential investments in this market environment.