PRIVATE MARKETS INSIGHTS:

PRIVATE EQUITY: A COMPLEMENTARY ASSET CLASS

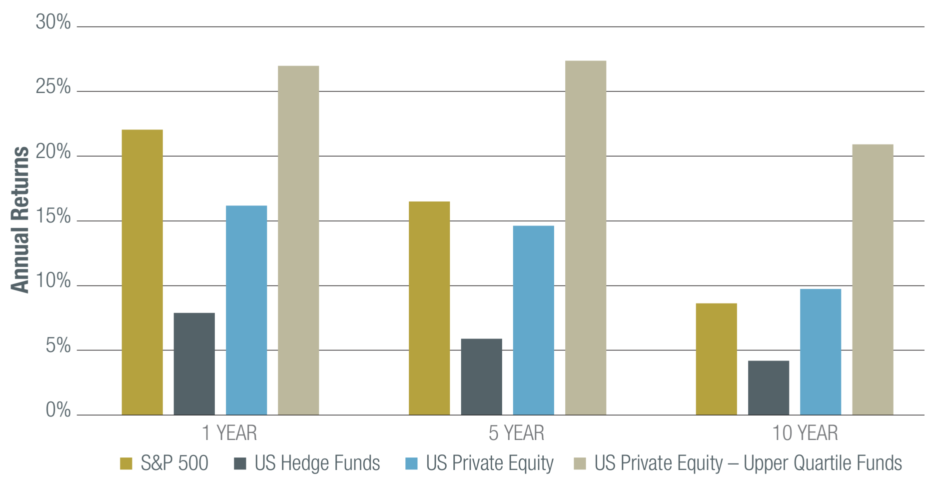
> **An allocation to private equity could prove complementary for those looking to improve overall portfolio returns and gain exposure to the substantial pool of investment opportunities beyond the stock market.**

> **For investors familiar with hedge funds, there are similarities with private equity, but differences in structure and target investments mean they have very different roles to play in a portfolio.**

With volatility rising in the equity market and returns from fixed income weak, investors might be well served by considering an allocation to private equity.

In addition to historically strong returns, particularly among top-performing funds (see Chart 1), private equity has limited correlation to traditional stock and bond investments, which can help reduce declines in the value of your portfolio during downturns in public markets.

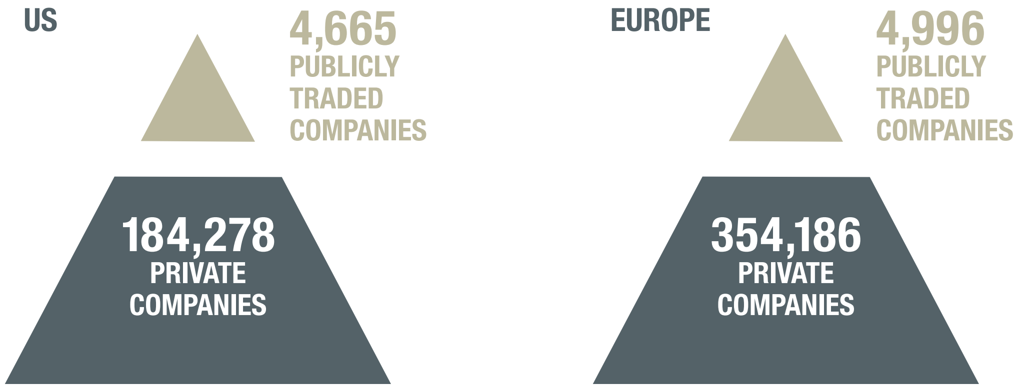
> CHART 1: Private equity investments have performed well historically
Horizon returns from different asset classes in the US



Source: Burgiss, Bloomberg. Data as of December 31, 2017.[1]

> CHART 2: Private equity significantly broadens the investment opportunity set

Number of companies, publicly traded vs privately held



Source: CapitalIQ as of December 5, 2017. Includes all private companies with revenues ≥ $10 million.

Furthermore, private equity provides exposure to the substantial part of the economy inaccessible via the stock market (see Chart 2). The unlisted economy presents managers with opportunities for outperformance given greater market inefficiencies, potentially allowing funds to capitalize on the rapid growth of star companies before they go public.

Yet despite strong historical performance and a broad opportunity set, relatively few individual investors have ventured into private equity. Hedge funds[2], in contrast, have become an established part of a balanced portfolio for individuals looking to reduce volatility and hedge specific exposures. This discrepancy in allocation is often simply due to a lack of familiarity with private equity, and private markets more broadly.

HEDGE FUNDS V PRIVATE EQUITY

For investors with existing hedge fund exposure, there are many elements of private equity that will be familiar. Both asset classes usually have limited correlation to public markets, seek to align investor-fund interests via fees linked to performance, and generally limit investor liquidity in order to make longer-term strategic investment decisions that can help maximize returns.

However, there are usually significant differences between the two in terms of the type and duration of those investments (see Chart 3). These differences may meaningfully impact the correlation of returns from private equity and hedge funds, making private equity a strong potential complement to both public market and hedge fund allocations.

BOTH PRIVATE EQUITY AND HEDGE FUNDS:

- **Have limited correlation to public markets**
- **Sell funds privately**
- **Are illiquid relative to public markets**
- **Limit investment withdrawal**
- **Charge management and performance fees**
- **Align interests with those of investor**

INVESTMENT STRATEGY

Generally, there is little overlap between the target investments of private equity and hedge funds.

Private equity, in its simplest form, involves investing in private companies and finding ways to later exit at a profit. This could be via either a minority stake, supporting and capitalizing on company growth (growth strategies) or a majority stake, actively executing strategies to add value to a business and exiting in a way that realizes that value (buyout/control strategies). Venture strategies often include a mix of minority and majority stakes.

Whichever approach is followed, private equity funds closely monitor and actively engage with the companies in which they invest. This is key to potentially mitigating some of the risk from investing in what are often less-established companies than those listed on public exchanges and generating stronger returns for investors.

> CHART 3: General differences between Private Equity and Hedge Funds

PRIVATE EQUITY		HEDGE FUNDS
Private companies	Investments	Mainly publicly-traded securities
Patient capital, positions typically held for 3+ years	Portfolio Turnover	Variable, but can be as frequent as intra-daily
Levied once specified rate of return achieved	Performance Fee	Levied immediately in most cases
Over defined multi-year (3-5 year) period	Capital Deployment	Immediate
At investment realization	Liquidity	With notice following initial lock-up period
Closed-end	Fund Structure	Open-ended
Gradual over lifetime of fund	Return Timing	By request, while some funds pay dividends

Hedge funds typically invest in one or many types of publicly-traded securities, and may adjust their portfolios as frequently as multiple times a day. The fees associated with this turnover have the potential to decrease investor earnings.

Though economic factors will influence the execution of each asset class's strategy, the sources of their returns are very different.

FEES

Private equity fee structures are fundamentally similar to those of hedge funds. Private equity funds generally charge a management fee based upon the amount of funds invested plus a performance fee based on returns.

Private equity funds almost all include a defined "hurdle rate" or "preferred return" – a rate of return below which fees are not charged. This means if a private equity fund investment fails to perform, investors will not pay a performance fee on that investment – creating a deep alignment of interests. An increasing number of hedge funds also include hurdle rates, responding to pressure from investors, though they remain less common than in private equity.

LIQUIDITY

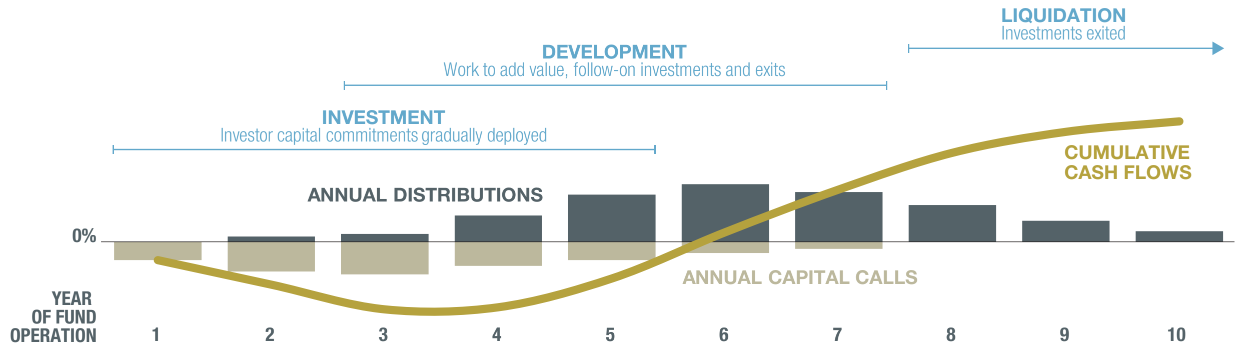
With private equity, investment selection and capital deployment can be lengthy, patient processes. Predefined investment periods of up to 4 or 5 years are standard, during which time the fund manager performs extensive due diligence before deploying capital to investments that fit its strategy. Returns are generally delivered as exits are made from the underlying investments, which can take several years.

Private equity funds do not permit withdrawals and are closed-end structures with defined lifespans. This illiquidity gives fund managers the freedom and incentive to exit investments at what they believe to be an optimal time. Managers may also feel freed from worrying about the impact of short-term strategic decisions, allowing them to focus on generating long-term value. As investments mature and the value creation plan is executed, managers will look to sell to the public markets or to a strategic or financial acquirer at a time and in a manner that aims to maximize returns.

With fund investment and fees preceding value creation and potential distributions, investor cash flows tend to be negative in the early years of a fund, turning positive later in the fund cycle as underlying investments are realized (see Chart 4). Once all investments have been exited and distributions made, the fund is wound down.

While public market hedge funds may offer greater liquidity than private equity, withdrawals are still restricted to monthly, quarterly, or even annual redemption "windows".

> CHART 4: Illustrative example of private equity fund investor cash flows



This example is shown for illustrative purposes only and is intended to demonstrate the mechanics and cash flows of a private equity fund. It is not intended to predict the performance or cash flows of any specific fund and should not be construed as predicting the future. The actual pace and timing of cash flows of a private equity fund are highly dependent on the fund's investment pace, the types of investments made by the fund, and market conditions. Private equity investing involves significant risks, including loss of the entire investment.

BENEFITS OF PRIVATE EQUITY EXPOSURE

Many institutional investors have carved out space in their portfolios for private equity. US state pension plans, for example, allocate an average of 9% of their portfolio to private equity[3], while foundations and endowments allocate 10.5% and 11.9%, respectively, to the asset class[4]. Reflecting satisfaction with the performance of private equity, the majority of institutional investors are still looking to increase allocations to the asset class: 53% of those recently surveyed planned to increase allocations to private equity in the coming years, with just 4% looking to reduce them[5].

Allocating to private equity could similarly help improve returns (as illustrated in Chart 1) for individual investors. These returns are furthermore derived from different sources than those of both hedge funds and publicly traded asset classes, adding an important layer of diversification to an investor's portfolio. This could help to limit potential downside in times of increased public market volatility.

Investors must, of course, always consider their overall investment goals and illiquidity tolerance, but private equity's strong historical track record makes it worth considering an allocation to the asset class.

To find out more about how HarbourVest can help you access private equity and achieve your investment goals, please get in touch with the Private Client Group at pcg@harbourvest.com or call 1-833-268-2200.

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[1] The US Private Equity return is a pooled IRR based on the combined cash flows of all private equity funds in the benchmark to limited partners after all fees, operating expenses, and carried interest. The S&P 500 is calculated on a cash flow-adjusted basis for direct comparison with cash flows into private equity. The US Hedge Funds return is a pooled annual return based on total returns data from the Hedge Fund Research HFRI North America Index benchmark. The securities comprising the public market benchmarks have substantially different characteristics than private equity benchmarks and the comparison is provided for illustrative purposes only. Investors should bear in mind that past performance is not necessarily indicative of future results and there can be no assurance that future private equity investments will achieve similar results.

[2] For the purposes of this piece, "Hedge Funds" refers to public market-focused hedge fund strategies

[3] Cliffwater, 2017 Report on State Pension Asset Allocation and Performance

[4] 2017 Preqin Global Private Equity & Venture Capital Report

[5] Preqin Investor Outlook: Alternative Assets, H1 2018

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