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Statement of BlackRock, Inc.
ERISA Advisory Council
Regarding Private Equity Investing by Pension Plans

July 19, 2011

BlackRock is pleased to be able to present its views to the ERISA Advisory Council concerning its study of hedge funds and private equity funds so that the Council may provide recommendations to the Department of Labor (DOL) concerning best practices for plan sponsors when making investments in these strategies and continued monitoring of these investments. The focus of our presentation will be on private equity funds.

BlackRock is one of the world's leading asset management firms. We manage over $3.65 trillion on behalf of institutional and individual clients worldwide through a variety of equity, fixed income, cash management, alternative investment, real estate and advisory products. Our client base includes corporate, public, multi-employer pension plans, insurance companies, third-party mutual funds, endowments, foundations, charities, corporations, official institutions, banks, and individuals around the world. Through BlackRock Solutions®, the firm provides risk management and advisory services that combine capital markets expertise with internally-developed systems and technology. BlackRock Solutions provides risk management and enterprise investment services for $9.5 trillion in assets

Essential characteristics of a private equity fund

In its broadest sense, private equity is simply the equity of businesses that are not publicly quoted or traded on a stock exchange. However, when investors refer to 'private equity' they primarily mean the provision of equity-related finance to effect change in a business, where the business was either originally unquoted, or becomes so after the transaction. The finance can be in the form of either common or preferred stock, or debt that has equity-like features, for example: convertible securities. Companies of interest to private equity investors need not be new, nor are they necessarily small.

Private equity fund managers can add value by building a portfolio through which they identify suitable target companies, structure the investment in those companies appropriately, and oversee their subsequent development, choosing the correct time to turn the investments back into cash. Private equity fund managers will be much closer to the business than is typical for portfolio managers of quoted equity investments. For example, a private equity general partner will usually be the majority owner of the company and will have the ability to hire or replace management, approve business plans and budgets, provide additional financing, and determine when to sell the company.

Private equity funds are typically closed-end partnerships with a life of 10-12 years (though often longer for funds of funds) and little liquidity. They are run by the general partner on behalf of the limited partners. Investors commit a fixed sum initially. Most of this is drawn down by the fund over the first few years of its life. Annual cash flow often turns positive after about four years as funds realize investments and distribute the proceeds to investors.

Private equity is highly illiquid. It is not suitable for investors with short-term investment horizons and those requiring all their assets to be readily realizable. The illiquidity, however, should mean that the returns from private equity include a compensating 'illiquidity premium' which makes it relatively attractive for long-term investors who are confident that they will not suddenly have to sell the assets to raise cash.

Private equity fund investments for defined benefit and defined contribution plans

Defined Benefit Plans

Private equity fund investments are a viable and important investment for defined benefit plans, and have been included as part of both US public and private plan allocations since the 1980's. One of the main reasons that defined benefit pension plans, along with other investor types, invest in private equity is to seek outperformance of the public equity markets over the long-term. According to a report from the GAO prepared in 2008, the defined benefit plan sponsors interviewed for the report stated that their private equity allocations generally had met their expectations (Source: "Guidance Needed to Better Inform Plans of the Challenges and Risks of Investing in Hedge Funds and Private Equity." United States Government Accountability Office, August 2008). Pension plan investment in private equity has been steadily increasing since 1979, when the Department of Labor first allowed private sector plans to begin making allocations to the asset class.

According to Greenwich Associates, 43% of defined benefit plans (with assets of $250 million or more) surveyed had investments in private equity as of 2006 (Source: Greenwich Associates and Pyramis Global Advisors, 2006).

Additionally, US pension funds represented approximately 57% of all private equity assets committed by US investors as of 2006 ("Institutional Investment in Private Equity" Grant Fleming; Private Equity: Fund Types, Risks and Returns, and Regulation, published in 2010, New Jersey).

Defined Contribution Plans

Defined contribution plans have not traditionally been investors in private equity funds primarily because private equity fund structures present problems relating to the requirements of defined contribution plans. Specifically, private equity funds are illiquid and are not valued daily, rendering them incompatible with the design features of most defined contribution plans.

Role of private equity funds in the investment strategy of defined benefit plan sponsors

Investors, including defined benefit plans, should avoid neglecting any asset class. Other things being equal, the best trade-off between risk and reward is likely to come from the most diversified portfolio. Just as defined benefit plans do not confine their quoted equity exposure exclusively to domestic equities, or their bond exposure just to government bonds, so they should not automatically confine themselves to publicly quoted assets.

The structure of private equity funds means that capital will be drawn for investment over time and that potentially not all of a defined benefit plan's commitment to a fund will be drawn over the life of the fund. In addition, cash distributions from realized investments are often distributed before a plan has fully paid-in their commitment, further reducing the plan's private equity exposure. As a result, defined benefit plans may need to 'over commit' to private equity and make new commitments as necessary in order to achieve their target exposure to the asset class.

Private equity is a well-established asset class for large pools of investment capital. Public pension plans on average allocate approximately 11% to private equity, while private sector pension plans allocate on average approximately 6% to private equity (Source: League Tables for US public pension plans, private sector pension plans, endowments and foundations as of 21 March 2011. Preqin. Average allocation to private equity represents weighted average based on institutional investors' total reported assets under management.)

Broadly speaking, defined benefit plans who are new to private equity should consider a commitment of up to about 5% of their total plan assets (although a limited commitment also implies limited potential benefits). Plans with more experience in private equity should consider a commitment up to 10%. Very experienced plans with faith in their ability to pick superior private equity managers could commit more than 10%

The appropriate allocation to private equity will vary from plan to plan and is largely based on the sophistication and resources of the defined benefit plan. These suggested allocations assume that the defined benefit plan does not face any legal or other constraints on investment in unquoted assets. Investors must confirm that this is the case prior to investing.

Benefit of including private equity investments in defined benefit plans

Investors, including defined benefit plans, have traditionally invested in private equity for two main reasons: the prospect of achieving enhanced long-term returns and portfolio diversification. Investors aspire to returns that are higher than those in the quoted market because they are buying into companies at the start of a period of rapid growth or change within the company. They also demand a premium for the illiquid nature of private equity investments and their higher risk.

Private equity, despite its higher risk, may also diversify a traditional quoted equity portfolio. Although many of the factors that drive the quoted stock market also influence the private equity market, private equity's returns are not perfectly correlated with those of quoted equity.

According to a recent research publication by Preqin, a research consultancy firm focused on alternative asset classes, "Private equity and fixed income are the only investment types to have generated positive horizon returns across the one-, three-, five- and ten-year periods as of Q2 2010; other asset classes fall into the red for at least one of the periods." (Source: "Public Pension Plans & Alternative Assets." Preqin February 2011, based on analysis of over 150 public pension funds in North America)

Investment risks of private equity funds relative to more traditional investment vehicles

<u>Illiquidity</u>
Private equity is intended for long-term investors who can accept the risks associated with making illiquid investments in privately negotiated transactions. Illiquidity may result from the absence of an established secondary market for such investments, as well as from legal or contractual restrictions. Investors typically may not sell, transfer, exchange, assign, pledge, hypothecate or otherwise dispose of their investment in a fund or withdraw from the fund without the consent of the general partner. Once committed to a fund, limited partners are effectively locked in for the full life of the fund and liable to the full extent of their capital commitment.

There is a small private secondary market in limited partnership interests that would allow a limited partner to sell its partnership to a third party. Such transactions, however, require the general partner's consent and often occur at a discount to the fund's NAV. Interests in a private equity fund are not generally listed on an exchange.

<u>Fund Selection</u>
One of the biggest risks in private equity investing is fund selection. There is no "passive index" for private equity so stating average performance metrics for the private equity asset class can be deceptive given the wide dispersion of returns among fund managers. The dispersion of returns between top and bottom quartile performing fund managers has historically been significantly larger for private equity fund managers than for traditional public equity fund managers. Top performing private equity funds generate an outsized percentage of the returns in the private equity industry, generating a skewed distribution and dragging average returns well above median returns. Therefore, if an investor is unable to identify and obtain access to the strongest fund managers, their private equity portfolio is unlikely to meet its target returns.

Additionally, research has shown that there is a high likelihood of persistence of performance among the top quartile fund managers. An in-depth study by Steve Kaplan and Antoinette Schoar ("Private Equity Performance: Returns, Persistence and Capital Flows." *Journal of Finance*, 2005) analyzed the likelihood of a top-third performing fund manager continuing to return top-third performance with subsequent funds.

The research showed that there was a 48% probability that the follow-up fund would also be a top-third performer.

However, many top performing funds are difficult to access. One reason is that these funds may have high minimum commitment amounts that may not be feasible or prudent for small or medium sized institutions to invest. Secondly, as these funds are closed-end and typically have a maximum amount of capital they will accept from limited partners, the funds that perform are often fully subscribed by prior investors who seek to repeat the success of past investments. Thus, high performing fund managers may have a strong enough investor base that they do not need to actively seek out capital from new limited partners.

Recommendations for plan sponsors for best practices in selecting private equity investments

Before deciding to invest in private equity, whether through a direct private equity fund or a fund of funds,, defined benefit plans should be sure that they clearly understand how the private equity fund is structured, what their required capital commitments will be and how they will receive proceeds from the fund. Additionally, it is critical that defined benefit plans understand the unique risks associated with the investment they are planning to make, and how those risks are balanced by the potential return and diversification benefits of the investment.

Each potential private equity investment should be subject to a rigorous due diligence process that examines the strengths of such investment's philosophy, people, process and performance.

• Philosophy — An organization's investment philosophy is what binds it together, determines direction and forms critical objectives. Defined benefit plans should look for general partners with clearly stated and proven investment philosophies, as well as the discipline to follow them.

• People — Driven by investment philosophy, a culture is formed. The quality and ability of its people allow an organization to realize its investment philosophy. Defined benefit plans should look for chemistry and cohesion within an organization, people who share a similar vision for success, and an appropriate compensation structure to attract and retain partners and investment professionals.

• Process — A structured and disciplined investment process is the glue that binds philosophy and people together to deliver results. Defined benefit plans should look for organizations whose process is scalable and who maintain procedural discipline in their deal sourcing, pricing, due diligence and exit strategies.

• Performance — Defined benefit plans should look for organizations that they believe have the potential to consistently provide high investment returns on a risk-adjusted basis. Exceptional investment performance is generally the result of stable investment teams with a consistent and successful investment philosophy who maintain a disciplined investment process.

A defined benefit plan's due diligence process should seek knowledge and an understanding of what may create value in a potential investment. It should generally include visits to the offices of the general partner, separate meetings with key decision-makers, analyses of prior fund returns, third party reference checks, and input from third parties that may have industry-specific knowledge. The key questions to answer from the analysis are — "What are the value drivers that the firm has used to generate returns, and can they be consistently applied in the future?"

It is important to remember that the appropriate allocation to private equity will depend on many factors, including a defined benefit plan's risk tolerance, liquidity needs and long - term investment goals. Because volatility and risk characteristics vary so widely between different private equity funds, the specific investments chosen typically are more important than they are in other asset classes. We strongly recommend that all defined benefit plans consult with a financial professional to determine what kind of allocation is right for them.

Recommendations for plan sponsors for best practices in monitoring private equity investments

Monitoring of private equity fund investments is a crucial aspect of risk management within an investment program's private equity allocation.

A defined benefit plan should monitor their private equity fund investments through ongoing due diligence by: (i) gathering and analyzing financial information (including annual and quarterly reports); (ii) attending annual meetings of the funds; (iii) actively participating on advisory boards and boards of directors whenever possible; and (iv) maintaining ongoing informal contacts with general partners.

Participating on a partnership's advisory board when possible is very important and benefits defined benefit plans by providing transparency to all general partners and underlying company investments. These benefits include:

- Helping to ensure compliance with the fund's strategy and agreed upon terms;
- More immediate access to portfolio company information; and
- Creating a constructive environment of accountability.

Diversification benefits offered by private equity investments

<u>Private equity as a portfolio diversifier</u>
Private equity's returns are related to those of the quoted market. Nevertheless, companies in the two markets differ in their size, maturity, industry profile and balance sheet structure; companies in private equity portfolios also tend to go through more rapid change. While the risk of private equity considered in isolation is higher than that of quoted equity, the two markets' returns are not perfectly correlated, so investing in both should provide diversification. Additionally, a modest allocation to private equity should not markedly increase total equity risk.

There are several important distinctions between private equity and public equity investing that potentially cause the returns of the two asset classes to be driven by different factors:

- Level of due diligence: private equity investors have access to proprietary, non-public information to bolster the decision-making process
- Control of investment: private equity investors take board seats as majority owners
- Strong alignment of interests: management, general partner and limited partner rewards are linked
- Talented management: Ability to attract entrepreneurs and skilled managers with equity ownership
- Value-added investing: private equity investors are operators vs. passive observers
- Time horizon: Longer-term investing allows the implementation of multi-year strategic planning as opposed to focusing on quarterly earnings reports
- Exit options: private equity investing has flexibility across IPOs, mergers & acquisitions and recapitalizations

A private equity fund manager has the ability to add value in all of these areas, drawing a contrast with public equity fund managers who are notably less able to do so.

<u>Diversification within Private Equity</u>
Defined benefit plans who are planning a significant long-term commitment to private equity should diversify their exposure by region, investment focus, vintage year, industry and manager.

The number of funds required to obtain reasonable diversification depends greatly on the nature of the funds and how specialized they are. A portfolio of about 25 to 35 diverse private equity funds should not have an overall risk markedly higher than that of the private equity market as a whole (although even with a larger portfolio, any collection of individual funds will not closely track the combined performance of the total market).

Diversification can improve a portfolio's risk profile. Diversification also can help boost the return on a portfolio. The return on a fund can be thought of as a multiple of the sum invested in the fund. The private equity market encompasses many funds with modest (or poor) performance and few funds with exceptionally good performance. Any given individual fund is more likely to be one of the many modest (or poor) performing funds than one of the few with exceptionally good performance. The exceptionally good performance of the few can nevertheless counterbalance the performance of the many to provide competitive returns on private equity as a whole. (The maximum loss of any one fund is essentially 100%, while the gain is potentially unlimited.) By investing in several funds, defined benefit plans increase the chances of including some of the funds with exceptionally good outcomes. In other words, diversification may help to increase the typical return potential on the overall portfolio.

Other options available to plan sponsors and participants seeking exposure to the unique investment opportunities offered by private equity investments, but that provide potential for daily liquidity and pricing

Quoted closed-end private equity funds offer some liquidity – they can be bought and sold like other quoted stocks – and funds' values are regularly published. They are subject to reporting and regulatory requirements similar to those of other quoted investments. The minimum investment is within reach of more investors. However, these funds often trade at a fluctuating discount to the reported net asset value of the portfolio and often do not have an appropriate level of float at any given time to be truly as liquid as traditional public equities. The funds are also more correlated with public equity market movements and can thus be impacted by broad market movements like other quoted securities. There is only a limited number of such funds, most of which are quoted on European exchanges and focus on European opportunities. Many of the available funds are also not appropriately diversified (by stage, industry, vintage year, geography, etc.) and may not be fully transparent with respect to underlying holdings.

Given the increased correlation with public equity markets, and the discount to net asset value at which they trade, we ultimately feel that publicly listed funds do not offer true diversified private equity exposure nor private equity-like returns to investors. However, given their daily liquidity, the funds may be viewed as "private equity-like" investment substitutes for plans where liquidity and daily pricing are overriding considerations such as defined contribution plans.

Direct investing in private equity investments compared to fund of funds

When investing in private equity funds, defined benefit plans may choose between investing directly in private equity partnerships (perhaps with the assistance of a consultant), or investing through a private equity fund of funds.

<u>Direct private equity fund benefits and drawbacks</u>**:**
The main benefits to direct private equity investing include the following:

- There are generally a wide range and number of private equity fund managers in which to invest;
- Fund managers generally have a high level of control in underlying company investments;
- The funds have a self-liquidating structure; and
- The funds are directly accountable to their investors.

The key drawbacks to investing directly in private equity funds include the following:

- Need for investors to achieve and maintain a good knowledge of the private equity industry and market conditions.
- It may be more difficult to monitor private equity managers, including their underlying fund holdings and investment performance;
- Minimum investment requirement per fund (often $5 million);
- Many popular and high-performing funds are closed to new investors; and

- Fund investing requires a high-level commitment of time and resources for a relatively small portion of an institution's total portfolio.

Additionally, the primary appeal of investing directly typically involves cost savings, though there are many hidden costs to a self-directed approach such as the following:

- It can be difficult, if not impossible, to properly diversify a private equity portfolio without substantial capital; and
- Consultants and non-dedicated private equity investors often have limited research resources and connections, which may lead to inadequate due diligence and adverse selection; for direct investing, consultants generally are not held to the same high standard of demonstrated performance, discipline of process, team stability, experience and infrastructure as a fund-of-funds.

<u>Private equity fund of funds benefits and drawbacks</u>
By contrast, advantages of an integrated effort coordinated by a properly aligned fund-of-funds manager may offer the following:

- Builds a diversified private equity portfolio;
- Has expertise in investing in private equity funds, knowledge of private equity mangers; performance, methods, portfolios, and fund-raising timing;
- Delegates control to the fund-of-funds manager, thereby saving management time;
- Offers an insight into private equity investment for those who do not yet wish to be involved with in-house or direct fund investment;
- Offers a wider range of pooled assets for smaller investments made by plan sponsors and individual investors;
- May offer current direct private equity fund investors a different and broader perspective of the private equity market;
- Sourcing of differentiated investment opportunities through network of industry relationships;
- Access to an established due diligence function and professional risk management;
- Cost-effective implementation of critical administrative systems and services;
- Established, audited track record; and
- Greater alignment of interest with investors in a pure fiduciary model.

The main drawbacks to investing in a private equity fund of funds include the following:

- Not being able to choose underlying fund investments;
- Additional layer of fees from the fund-of-funds manager;
- Possible over-diversification; and
- Limited contact with the underlying private equity fund managers.

Investing in private equity investments to gain access to these strategies as compared to investing in more traditional investment options that may utilize similar strategies

<u>Benefits to private equity investing</u>
Private equity invests in privately-held, unlisted (and therefore illiquid) companies' equity where it will usually (alone or together with like-minded investors) acquire a majority stake. In contrast, traditional investment options typically take minority positions in heavily-traded, highly-liquid securities in public companies, currencies and commodities.

Private equity also does not implement short selling strategies. In contrast to traditional investment options and even hedge funds, commitments to private equity and venture capital funds are of a long-term duration (typically 10 to 15 years) and are not subject to monthly, quarterly or annual liquidity terms, which may in themselves be a source of market volatility. (Source: "Private Equity and Venture Capital in the European Economy…" EVCA 2009)

Additionally, private equity investing differs substantially from traditional investment options since it involves active ownership and control over a company's management, board, operations, and capital.

Managers can thus be thought of as “owner operators” who are able to use their concentrated ownership to exercise tight oversight over management and implement change. Private equity investments are “drivers for change” by financing business growth, operational change, or strategic acquisitions. Such investments can be in the form of either equity shares or debt that has equity-like features and cover companies of all sizes and in all stages of its life cycle. Meanwhile, traditional asset class and hedge fund investors have limited ownership rights that would enable them to add value to a company.

Private equity managers also undertake a robust due diligence process when evaluating investments and are able to make more informed investment decisions based on proprietary, non-public information. Managers generally conduct hands-on, thorough quantitative and qualitative analyses of each investment opportunity, including: financial and valuation analyses; reference checks with current and prior investors, portfolio company management, accountants, investment bankers, and attorneys; as well as third party research. Public equity managers rely solely on publicly available information to base their decisions and do not have access to non-public information.

In addition to having a superior governance model and access to proprietary information, private equity investing tends to have a strong alignment of interests between fund managers, company management, and investors. Typically, fund managers and their senior professionals are aligned with investors through profit sharing arrangements (or “carried interest”) on cash received from investment sales and/or dividend recapitalizations. Managers and their senior professionals will also invest alongside investors at the fund and underlying company levels. Fund managers do not receive any share of the profits unless profits are distributed to investors, who must receive their invested capital plus a pre-established rate of return (or “preferred return”). Funds may have “claw back” provisions which force managers to pay back any previously earned carried interest should the investors’ compounded rate of return drop below the preferred return. Traditional asset classes and hedge funds typically recognize profits (and associated performance fees) yearly (or more often) based on the spot market value of the assets held whether cash is distributed to investors or not.

The management of underlying companies is also economically incentivized to achieve results and generally co-invests considerable equity stakes in the company from their own resources. Management is also rewarded through equity options and other incentive arrangements. Fund managers believe that offering such investment rewards is crucial to attract the executive talent needed to add value by executing their business models. It is actually rare for the management of portfolio companies to be offered compensation arrangements not linked to company performance and business plan execution. (Source: “Private Equity and Venture Capital in the European Economy…” EVCA 2009)

“In contrast, the executive compensation for public company management is generally not correlated with shareholder returns – but, rather, with company size. Such executives are thus more concerned with short-term, quarterly performance rather than building long-term shareholder value. It is also common for compensation to include generous severance terms which tend to be seen by many outsiders as “rewards for failure” when they are triggered. And the non-executive directors of public companies are usually awarded a flat fee – consistent with their major de facto role of overseeing compliance with the rules of the financial marketplace, not driving performance.” (Source: “Private Equity and Venture Capital in the European Economy…” EVCA 2009)

Private equity investments also have long-term investment horizons (generally three to five years) which allow fund managers to effectively manage an underlying portfolio company without distractions. Managers have the ability to implement change and add value with general freedom from pressures of the stock market, media and Wall Street analysts, as is the case with pubic equity investments. There is also no pressure to sell an investment until the markets are ripe and the business is ready. Managers have the ability to exit portfolio companies through multiple options such as an IPO, M&A transaction with a strategic buyer, or a recapitalization of the business. Unless the company is in distress, the manager can choose the right to time to exit the investment without concern over stock prices. In addition, because private equity is illiquid and does not allow redemptions, private equity managers are never forced to sell an investment at the wrong time in order to meet client redemptions.

In the end, private equity investing provides investors, including defined benefit plans, with the potential to add genuine alpha to their portfolios as well as modest overall diversification. On an absolute return basis, US buyouts have outperformed US pubic equities by approximately 3-5% per annum. When adjusting pubic equity market performance for the industry, company size, and leverage biases of buyouts, we also see that US buyouts outperforms US pubic equities by 5% per annum (Source: "Do Buyouts Outperform?" Jason Malinowski/BlackRock, 2010). One can theorize that this outperformance (or "alpha") is the consequence of the aforementioned benefits (particularly governance models and greater alignment of interests) which private equity exhibits when compared to traditional asset classes (Source: "Pioneering Portfolio Management." David Swensen, 2000.).

Investing in private equity funds or fund of funds also requires a certain level of alpha versus public equity markets in order to compensate investors for holding a long-term, illiquid investment. Is the additional 3-5% per annum adequate compensation for a 10-15 year illiquid investment? In other words, the additional illiquidity may be necessary for alpha so that management can focus on long-term value creation instead of short-term, quarterly earnings releases as is the case with public equity (Source: "Do Buyouts Outperform?" Jason Malinowski/BlackRock, 2010).

<u>Drawbacks to private equity investing</u>

The primary drawbacks to private equity investing are illiquidity and adverse manager selection. Direct private equity fund investments lack liquidity but do trade on a secondary market, usually at a discount to net asset value. Meanwhile, private equity fund of funds trade at steep discounts to net asset value in a very limited secondary market. Defined benefit plans must be in a position to accept the inherent illiquidity and required long-term commitment within their portfolios. Defined benefit plans can also experience substantial risk of loss if they do not properly diversify their private equity exposure across vintage years (in order to diversify across the economic cycle), regions, and segments of the market. Private equity investments, particularly venture capital and growth equity, may also invest in immature markets that may result in a complete loss of capital should the underlying business fail.

For direct fund investing, the greatest risk is adverse manager selection. According to the Thomson One Venture Economics database, there is a wide disparity in performance between bottom quartile and top quartile funds for both buyout and venture capital funds. As of 31 December 2010, top quartile US buyout and venture capital funds have outperformed bottom quartile funds by 29% and 51%, respectively, in annualized net internal rate of return terms. It is therefore crucial for defined benefit plans to have the resources and staff available to conduct detailed due diligence on fund managers (Source: Thomson One Venture Economics database – Pooled horizon net IRRs for the 15-year period ended 31 December 2010, derived on 2 May 2011).)

Role of investment managers, advisors and consultants with regard to due diligence and ongoing monitoring to meet the needs of plan sponsors

<u>Private equity fund of funds managers, advisors and consultants</u>

We believe that a private equity investment manager's primary role should be to act as a fiduciary for their clients. Managers should partner with their clients to understand their unique investment goals and requirements and develop solutions together. For many large institutional clients, this may result in relationships that go beyond traditional investment management assignments to create broader strategic partnerships, assisting in designing portfolio strategies that support clients' enterprise level objectives, taking into consideration their tolerance for risk on both an economic and accounting basis.

As fiduciaries, investment managers should also seek to educate their institutional clients on the investment characteristics and suitability of all investment products and asset classes. At the most intense level, managers may embed a client's staff in their organization in order to learn the manager's best practices in detail, in both fund investments and direct co-investments as is the case with private equity. Investment managers also may offer general training sessions for clients.

For defined benefit plan sponsors and other institutional investors who are considering private equity investing, it is also important for managers to act as a "window" for their clients to the private equity world.

For example, in the context of providing face-to-face detailed quarterly portfolio reviews with our major clients, we also provide a detailed update on the private equity and related markets. Additionally, we publish a quarterly private equity market commentary. We also offer other avenues of information sharing for defined benefit plan sponsors and other larger institutional investors:

- Access to our team on a daily basis to discuss private equity markets and companies in the marketplace;
- Invitations to investor conferences, giving the opportunity to meet not only members of our investment team but also other private equity investors; and
- Periodic topical presentations to a client's staff and board.

Consultants and advisors generally do not function as fiduciaries for their clients since they lack discretionary investment authority (in most cases) as an investment manager does. In addition, consultants and other investment advisors often have limited research resources and connections, which may lead to inadequate due diligence and adverse selection. For direct fund investing, consultants generally are not held to the same high standard of demonstrated performance, discipline of process,

Private equity direct fund managers
While private equity fund of funds managers are primarily involved in the construction and management of an institutional investors' private equity program, direct private equity managers are focused on adding value in underlying company investments. Specifically, top-performing direct private equity managers add value through the following five areas with respect to underlying company investments:

- Portfolio construction: Private equity funds must determine the relative allocation to different industry sectors and geographical regions, and sometimes to the different stages of investment, for instance venture capital versus buyouts. Prudent private equity managers must resolve the tension between the desirability of geographical and industrial diversification, on the one hand, and of exposure to the most attractive deals on the other. In practice, investments are often concentrated in the sectors where the manager perceives the greatest opportunities.
- Deal flow and selection: Private equity managers research many more opportunities than they eventually select. This research requires a number of financial and industry contacts to ensure adequate deal flow and also requires an experienced private equity investment team. A private equity manager with a strong reputation is more likely to be approached by higher quality entrepreneurs and company managers.
- Structuring deals: Structuring individual private equity deals requires negotiations both with the target company and with banks and other potential providers of debt finance. Negotiations with the company cover not only the sum to be invested and the size of any equity stake, but also will include contracts and equity incentives intended to motivate company management to act in line with the fund's best interests. The relative proportions of equity (provided by the fund) and debt affect the risk and potential reward of the fund's investment.
- Managing the investments: When investing, the private equity manager will attempt to make the changes required for the company to be sold at a significantly higher price, and within a reasonable time frame. Most private equity investors see themselves primarily as managers of the company's managers as the business moves toward those goals. They will usually require representation on the company's board and compensation committee and will provide strategic advice, but generally are reluctant to get involved in the day-to-day running of the company.
- Exiting the investments: A successful manager also needs to determine when to exit investments, and by what means. Ideally, this will occur when the change the fund set out to effect has been completed and when the market environment makes a sale attractive. The manager should then negotiate terms that minimize any restrictions on a sale post an initial public offering (IPO) or a strategic sale, so that cash can be distributed quickly to limited partners. Financial and industry contacts are important when identifying potential buyers.

Impact of private equity investments on the broader financial economy

The global private equity and venture capital industry has experienced significant growth during the past decade and remains a critical source of finance and expertise for companies seeking to achieve their growth aspirations. In fact, industries with private equity activity experience more rapid growth (as measured by total production, value added and employment) with no more volatility relative to industry cycles than industries without private equity activity. From 1991-2007 across all OECD countries, gross production (or value of goods and/or services produced), value added (or industry contribution to national GDP), and total employment within private equity-backed industries was 0.5%, 0.3%, and 0.6% higher per annum than non-private equity industries. These figures underscore the aggregate value added by private equity investing to the world economy. (Source: "The Global Impact of Private Equity Report 2010." World Economic Forum, 2009)

In addition to contributing to global economic growth, evidence strongly suggests that private equity-backed firms have improved operations and profitability. Productivity grows on average by approximately 2% more at private equity-backed firms within the first two years following a transaction than at non-private equity firms. (Source: "The Global Impact of Private Equity Report 2010." World Economic Forum, 2009)

Private equity investing also plays a crucial role in the economic development and growth of emerging markets economies. Over 300,000 jobs were created across a sample of 522 firms in emerging markets. The sample also had a mean annual job growth rate of 22% versus 3% for the broader regions containing the sample firms. (Source: "The Case for Emerging Market Private Equity." International Finance Corporation, 2009)

In addition to emerging markets, the US has historically seen strong job creation following private equity transactions despite claims to the contrary. From 2000 to 2007, the US economy added seven million jobs at an annual growth rate of 5.5%. A sample of 26 private equity-backed firms added jobs at an annual rate of 12.3%, or 7.8% higher than the broader economy. Manufacturing firms saw a one million job detraction at an annual rate of -7.7%. Those manufacturing firms backed by private equity, meanwhile, grew jobs at a rate of 1.4%, or 9.1% higher than the broader industry. Private equity funds identify inefficient companies or subsidiaries, leverage those companies' assets to borrow much of the financing to purchase a controlling interest, reorganize their operations and management, and run the reengineered firms as privately-owned entities. While private equity investors may initially reduce headcount at targets with low labor productivity and over-employment, over the long term these companies may still add jobs as their growth picks up in the future. (Source: "American Jobs and the Impact of Private Equity Transactions." Robert Shapiro and Nam Pham, 2008)

ERISA fiduciary obligations of private equity funds

In most cases, private equity fund activities are not "themselves" subject to ERISA fiduciary obligations because the funds are structured so that their assets are not considered "plan assets" for purposes of the ERISA rules. In particular, private equity funds either qualify as venture capital operating companies ("VCOCs") or rely on the so called "25% exception to a fund being subject to ERISA. VCOCs are private equity funds in which at least half of the portfolio investments comprise interests in operating companies as to which the private equity fund has contractual management rights (e.g., the right to appoint a director). Private equity funds relying on the 25% exception, limit participation to the fund by benefit plan investors to less than 25% of any class of the fund's equity interests.

If a private equity fund is subject to ERISA the manager is deemed a fiduciary with respect to the assets held by plans and the activities of the fund are subject to ERISA's fiduciary and prohibited transaction rules. In cases where the fund manager is subject to ERISA, it will have extensive compliance procedures in place to ensure compliance with the additional requirements imposed by ERISA.