Private equity can play an important role in portfolio construction as it helps investors diversify into an asset class that has a low correlation to the public markets while also increasing the overall return potential of a portfolio.

Some investors view PE as an extension of the equity and fixed income portfolio and then apply a level of illiquidity risk to determine an appropriate allocation.

- Equity oriented strategies of PE—including buyout, venture capital, and growth equity—invest in the equity tranches of a company’s capital structure.
- Debt oriented strategies of PE, such as mezzanine or direct lending, invest in debt instruments issued by a private company.

The chart below shows the “liquidity spectrum” across different strategies and asset types and reflects the basic, intuitive concept that investors should receive a higher premium as the degree of illiquidity increases. The most liquid market in the world (US Treasuries) offers essentially zero illiquidity premium as all investors have the same information and can transact instantly with little risk, while the most illiquid market (venture capital) depends on information shared person to person and negotiated valuations. Investors should evaluate where their investment ranks in the capital structure and whether the return potential is worth the illiquidity.

### ALLOCATING ACROSS THE LIQUIDITY SPECTRUM

<table>
<thead>
<tr>
<th>MORE LIQUID</th>
<th>LESS LIQUID</th>
</tr>
</thead>
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<tr>
<td>Equity</td>
<td>Actively Managed Mutual Funds</td>
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<td>Equity ETF/ Index Funds</td>
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<td>Real Assets</td>
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Past performance does not guarantee future results. This example is provided for illustrative purposes only and describes the general liquidity of certain product types. This information may be incomplete and the liquidity of any particular product may vary. Investors should consult a fund’s offering materials regarding the liquidity characteristics of that product.
INVESTMENT STRATEGIES

Many private equity firms specialize in a certain company life stage, strategy or industry. Common private equity strategies include (but are not limited to):

**Venture capital**
Venture capital firms provide funding to entrepreneurs and early stage companies that they believe have the potential to scale and disrupt their markets. In addition to providing capital, venture capital managers often provide expertise to help these start-ups refine their business plans and bring their products to market. Venture capital firms commonly build investment and/or operating teams and advisors with deep experience in a particular industry, who are highly networked within their sectors and can generate proprietary dealflow and credibility for their firms.

**Buyout**
Most investors think of buyouts when they think of private equity strategies. Private equity firms that focus on buyouts take control of a company’s assets and/or operations by purchasing a majority of the voting stock of the target company. A “leveraged buyout” (LBO) describes transactions that use substantial debt to purchase the control of the target company. While the use of leverage in this context is very common and can increase equity returns, it also adds risk in that the company must be able to service the additional debt. Within the buyout category there is stratification by size, with certain managers targeting very large and complex enterprises, others focusing on the middle market, and a final group targeting small scale firms.

**Growth equity**
Growth equity strategies focus on companies that are past the start-up stage and have some proof of concept, but that are still growing into their run rate size. This strategy can be thought of an intermediate step between venture and buyout, and is sometimes paired with one of these other strategies within a single fund.

**Mezzanine**
Mezzanine debt sits below senior debt and above equity in a company's capital structure. As such, it will have higher yields and risk relative to senior debt, and generally less upside but also less risk relative to equity. Mezzanine investments offer a pre-specified coupon and are either unsecured or secured by a second lien on the company’s collateral (with the first claim on assets held by the company’s senior lenders). Mezzanine debt also often comes with equity conversion features such as warrants or other rights, which can potentially further enhance returns.

**Direct lending**
Direct lending has become a popular subset of the private credit space in recent years. While mezzanine loans to companies may be unsecured or secured by a second lien on the company’s assets, “direct lending” is often used to describe senior secured (i.e. first lien) loans which companies have traditionally sought from banks. Due to increased regulation many banks have pulled back their lending activity, allowing private funds to step in and provide this type of financing, particularly in the middle market.

**Distressed Debt and Special Situations**
Traditional distressed debt investing is a trading oriented strategy where the manager takes advantage of price movements in a company’s high yield bonds or other debt to make a profit (fundamentally, buying low and selling higher). This type of distressed debt investing is a non-control, public market focused strategy where the key risk is avoiding companies headed for insolvency. A variant on this strategy is “distressed for control”, where the manager expects that some subset of companies will enter into a restructuring process and accumulates a debt position with a view to gaining influence in that process and ultimately, control of the company post-reorganization. Once in control of the reorganized entity, the manager will act as a typical buyout manager to maximize the equity value of the company, and ultimately exit. Special situation or “turnaround” investing involves an equity investment in a stressed company that the PE manager believes they can turn around and set on the path to profitability by bringing cost-cutting, strategic repositioning and other operational improvements to bear. Certain managers either specialize in a single distressed investment sub-strategy or raise funds dedicated to individual sub-strategies, while others execute both debt and equity focused approaches under the same umbrella.
INVESTMENT STRATEGIES

Real asset strategies can indicate energy, infrastructure or real estate focused funds. While each of these are backed by tangible assets, they have very different investment profiles. Energy managers variously make equity and debt investments and may specialize in a particular segment of the energy industry such as upstream E&P (extracting oil and natural gas from the ground), midstream (resource transportation), services (refining or other services necessary to obtain resources or make them saleable) or renewables (wind, solar, hydro, biomass). Energy strategies incorporate significant commodity risk and accordingly many managers hedge commodity exposure to de-risk their portfolio companies’ revenue streams. Infrastructure funds tend to generate lower returns than other private equity strategies, but are lower risk in that the targeted assets (toll roads, airports, ports, etc.) are necessary to basic economic activity. Power generation assets are often found in both energy and infrastructure funds. Real estate managers, like energy and infrastructure focused managers, tend to focus on either debt or equity investments and have a range of asset types in which they can invest (office, multifamily/apartments, hotels, industrial/storage facilities, etc.). Depending on their area of expertise, real estate firms may focus on either core/core plus assets (stabilized, fully leased, income generating properties) or take more of a value-add/opportunistic approach by targeting properties with repositioning, lease up or financial restructuring upside. Certain managers may engage in ground up development, which is referred to as greenfield investment in the energy or infrastructure context.

Another common private equity strategy is secondaries. In a secondary sale, an existing investor in a private equity fund sells their interest in the fund before it has fully matured. Depending on when in the fund’s life the interest is sold, the investor may still have contributions to make or the underlying fund’s investment period may already be over (meaning the buyer is purchasing a stake in a fund that is already in its distribution phase). Secondary funds can be attractive because they provide diversification across managers and vintage years, have a shallower J-curve profile than traditional private equity funds, and can have more predictable outcomes than traditional private equity fund investments in that the buyer has the ability to evaluate assets already purchased, rather than committing to a “blind pool” that has not yet made any investments. However, secondary fund managers charge fees in addition to the fees due on the underlying fund stakes that they purchase. In addition, whether a secondary fund interest is purchased at a discount or premium to its net asset value (“NAV”) can have a determining effect on the ultimate performance of that investment.
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