# THE BENEFITS OF CONSISTENT AND DIVERSIFIED PRIVATE EQUITY ALLOCATION

Investing in today's uncertain environment is a challenge. Equity valuations remain stretched even as volatility has risen sharply, bonds are under pressure, and multiples are elevated in private markets, making it tough to see potential investment upside. It is therefore important to consider the fundamental purpose of private equity within an investment portfolio. For most investors, private equity helps limit downside risk while providing strong returns derived from different sources than publicly traded asset classes. Private equity provides diversification benefits by deploying capital over an extended period of time and investing in companies across industries, stages – including venture, growth and buyout – and geographies. Additionally, its inherent illiquidity and the fact that investments are typically valued on a quarterly, not real-time, basis reduces portfolio volatility. Put simply, private equity's purpose, strategy, and capital deployment structure are very different from the public markets, so it makes sense to invest in it very differently.

The private equity fund model means that commitments are called up over an extended period of time – often as much as four years. So the capital committed today could well be deployed in a very different business environment, and certainly over the typical 10-year primary fund period investors are likely to invest through an entire economic cycle. Given this near impossibility of determining which vintages will perform best, a diversified allocation minimizes the risk of missing out on a top-performing one. A diverse portfolio produces a lower combined risk than the individual risk associated with any single asset class.

A well-balanced private equity portfolio should be fully diversified across strategies, geographies, asset and sub-asset types, stages, and managers. Complementing primary fund investments with secondary and co-investment strategies further increases diversification and can enhance both returns and cash flow consistency. Secondary investments can generate earlier appreciation, helping to mitigate the J-curve frequently associated with primary investing as well as improve private equity portfolio liquidity. In addition, they can provide backwards time diversification by offering access to prior vintages. Further, co-investments – investing directly into operating companies alongside fund managers – can help lower costs and shorten the J-curve via more rapid deployment. They can help generate alpha via a more concentrated approach, albeit with increased investment risk.

Cambridge Associates' analysis of asset and sub-asset class performance data, shown in the chart below, highlights the near impossibility of picking a single, consistently winning strategy. The data suggests that investors should allocate to a diversified set of asset classes, given the significant variation in returns by category from year to year. Diversifying with an even weighting across different managers helps to reduce idiosyncratic, manager-specific risk. In addition, investing in managers across market stages – from large to micro-buyout funds, as well as venture funds – can both enhance returns and increase downside protection. Geographic diversity is also important in improving risk-adjusted returns. Adding global exposure improves downside risk protection. They are not perfectly correlated and may offer upside at times of weaker US performance.

| 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 104.4 | 83.1 | 33.4 | 11.8 | 17.4 | 25.3 | 29.9 | 20.3 | 20.3 | 11.7 | 9.1 | 13.9 | 16.9 | 20.6 | 23.7 | 15.0 | 19.0 | 18.3 |
| 28.1 | 18.7 | 14.7 | 9.5 | 16.6 | 23.4 | 22.2 | 20.2 | 18.4 | 10.8 | 8.2 | 11.4 | 14.8 | 19.1 | 18.1 | 20.6 | 18.6 | 17.4 |
| 19.1 | 14.5 | 11.5 | 9.4 | 15.3 | 20.2 | 17.8 | 16.1 | 15.3 | 8.9 | 8.0 | 9.8 | 14.2 | 16.3 | 15.9 | 19.3 | 17.0 | 15.8 |
| 13.3 | 10.4 | 9.3 | 8.9 | 12.4 | 18.8 | 16.2 | 16.0 | 12.4 | 8.8 | 7.9 | 9.7 | 13.4 | 15.2 | 15.3 | 18.0 | 16.9 | 15.6 |
| 5.9 | 10.1 | 8.0 | 6.0 | 10.3 | 13.5 | 15.8 | 15.9 | 11.5 | 8.5 | 7.3 | 9.5 | 13.2 | 15.2 | 13.5 | 17.5 | 16.4 | 15.2 |
| 4.8 | 9.9 | 5.1 | 2.7 | 7.9 | 9.7 | 5.4 | 12.2 | 6.6 | 8.0 | 7.3 | 9.1 | 12.4 | 14.6 | 13.3 | 17.3 | 15.1 | 13.6 |
|  |  | 2.3 | -0.7 | 0.0 | 3.4 | 1.3 | 8.4 | 4.5 | 7.2 | 7.0 | 9.0 | 9.8 | 8.9 | 11.9 | 16.2 | 14.6 | 13.2 |

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