JOHN P. ALOUFT
Senior Investment Officer
Virginia Retirement System

The Virginia Retirement System (VRS) is a $43 billion pension fund with seventy different general partners. We invest solely in limited partnerships. We are in about two hundred different funds, and our net return since 1989 is 23.7 percent.

Private equity is an investment in securities that are not traded in public markets. The asset allocation we have for the VRS is a mix between venture capital, buyouts, mezzanine, distressed, and energy. Our investments in the buyout market are essentially making acquisitions using a mix of debt and equity in the United States, usually about 60 percent debt and 40 percent equity. For venture capital and growth, they’re primarily all equity financing based on the lack of earnings in these businesses. Mezzanine financing is like a middle layer, subordinated to debt. It is senior to the equity and is primarily seen as a current return with some upside through equity kickers such as warrants.

Why do we invest in private equity? To generate superior returns to the public markets. But as mentioned earlier, if you do not invest with a top quartile manager, your performance is going to be minimal, at best. It is a nice diversification tool for the portfolio but it’s also a long, illiquid investment. The partnerships we invest in are typically for ten years. The first half of that is pretty much the investment period, while the second half is the maturation or distribution period, where they’re harvesting the investments that have been made.

There is an alignment with the general partners, in that they do receive a substantial profit allocation, typically 20 percent of the overall gains in each partnership. To explain this, look at the J-curve effect (see Table 5, p. 30). During the first three years or so, net cash flow becomes more and more negative. As goals are realized, cash flow starts turning upward and hopefully you’re going to reach a profitable investment by the sixth year. Historically, private equity has outperformed public market returns (see Table 6, p. 30), and there’s a huge difference between managers as well (see Table 7, p. 30).

I’ll talk a little bit about current investment opportunities and what we find attractive. In the U.S., we like middle-market buyouts, or funds between $250 and $750 million. In Europe, we also like middle-market buyouts, but I am very cautious about investing in venture capital there. It is starting to mature, but the returns have not been overwhelming so we’re extremely selective. There’s also blue chip venture capital, but that’s a very select group of partnerships that are difficult to get into.

One way to provide liquidity in private equity is to use the secondary market. It’s becoming quite mature, and as maturity occurs in any asset class, returns are going to decrease. However, the volume of secondary opportunities seriously outweighs the amount of capital to be invested, so some figure that the return is not going to decrease for a while.

From 1991 through 2001, there was a huge increase in the amount of venture capital commitments due to the Internet bubble. When the Internet bubble burst, companies started rationalizing their investment strategies and raising smaller funds. So even though venture capital deals were substantially smaller, the desire for pension funds and endowments to invest in venture capital increased.

Here’s an explanation of the difference between private equity versus hedge funds. Private equity is more of an illiquid asset class of controlled positions, whereas hedge funds use trading strategies. There’s some major discussion going on right now that blurs the distinctions between hedge funds and private equity. This is, I believe, due to the fact that hedge funds are striving to find higher return areas, and a lot of people believe that in the next five years, you’re not going to have private equity and hedge funds, that it’s really just going to be a combination called alternative assets.

We began our portfolio with a top-down approach and now have a very mature, diversified portfolio (see Table 13, p. 32). It started with a macro top-down approach but then switched to a bottom-up approach: we selected the best partners and focused on adding value to the existing portfolio.
The main reason why you should be looking into private equity is for superior risk-adjusted return. The VRS is a $43 billion fund. We have a 5 percent allocation in private equity. Within that allocation, we have varying sub-sectors with a different risk return profile. This affects our overall mix, asset allocation, and the opportunity to put substantial dollars to work in specific asset classes.

When you decide to build a program, it takes specialized resources, and there are two ways to do this. Although it takes time, you can either build those resources internally, or you can utilize external expertise. I think the best way is to do a combination of the two. Hire outside help to get the program going, but at the same time have an internal staff that is being educated by this external specialist to develop a portfolio.

There’s a substantial increase in private equity investments in both Europe and North America (see Table 16, p. 33). In my perfect world, I would like to see 40 percent venture capital, 40 percent buyout, and 20 percent distressed, growth, and other special situations. At VRS, our venture capital allocation is 18 percent. We are in some very good, brand-name venture capital firms and we’re trying to get as large an allocation to them as possible, but we are not going to stretch to invest venture capital dollars just to fill up a bucket.

You also need vast, specialized resources to deal source, find the best opportunity set possible, conduct due diligence on specific groups, monitor investments, and do the accounting. What are some strategies to overcome resource constraints? Start off with an adviser, hire a staff to work with the adviser to learn the ins and outs of the business, develop your own expertise, and then wean off the consultant.
SLIDE 3
Types of Private Equity Investments

Buyout
- The acquisition of a company in which the purchase is leveraged through loan financing. The assets of the company being acquired are put up as collateral to secure the loan. Buyout managers utilize financial structuring and operating expertise to improve company financials and position the company for a strategic sale.

Venture Capital and Growth Capital
- Investment capital utilized for starting and building companies. Venture capitalists invest in equity in the form of common stock, preferred stock, or other financial instruments convertible into common stock and exit their investments through an initial public offering.

Mezzanine Financing
- A middle layer of financing in buyout and growth investments, subordinated to the senior debt layer, but senior to the equity layer. Mezzanine financing shares characteristics of both debt and equity financing.

SLIDE 4
Characteristics of Private Equity
- Superior returns over the long run
- Solid returns during periods of low economic growth
- Increased portfolio and asset class diversification
- Long-term, illiquid investment
- Returns depend greatly on manager selection
  - To quantify the amount of value creation created by a private equity firm, a clear understanding of valuation methodologies is needed
  - Valuation standards currently lack consistency and vary from manager to manager
- Alignment of client interest with GPs
- "J-curve" effect

Upper quartile private equity funds have outperformed other asset classes returns over an extended period of time and have generated solid returns throughout periods of low economic growth.

SLIDE 5
The J-Curve Effect

Typically, private equity returns follow a "J-curve," where early drawdowns result in large net losses to private equity investors, as illustrated below.

Private equity cashflows are typically described by the "J-curve."

SLIDE 6
Performance in Private Equity


<table>
<thead>
<tr>
<th>Year</th>
<th>Total Quarterly</th>
<th>Average</th>
<th>Median</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>10.4%</td>
<td>4.5%</td>
<td>4.5%</td>
</tr>
<tr>
<td>2005</td>
<td>10.9%</td>
<td>4.5%</td>
<td>4.5%</td>
</tr>
<tr>
<td>2006</td>
<td>10.6%</td>
<td>4.5%</td>
<td>4.5%</td>
</tr>
<tr>
<td>2007</td>
<td>6.5%</td>
<td>4.5%</td>
<td>4.5%</td>
</tr>
</tbody>
</table>

Historically, private equity has outperformed other asset classes.

SLIDE 7
Importance of Manager Selection

Quartile Performance, All U.S. and European Private Equity

United States

<table>
<thead>
<tr>
<th>Quartile</th>
<th>10-Year</th>
<th>20-Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lower 1st</td>
<td>10.5%</td>
<td>33.1%</td>
</tr>
<tr>
<td>Upper 1st</td>
<td>21.0%</td>
<td>53.0%</td>
</tr>
</tbody>
</table>

Europe

<table>
<thead>
<tr>
<th>Quartile</th>
<th>10-Year</th>
<th>20-Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lower 1st</td>
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<td>33.1%</td>
</tr>
<tr>
<td>Upper 1st</td>
<td>21.0%</td>
<td>53.0%</td>
</tr>
</tbody>
</table>

Quartile analysis of aggregate private equity fund performance indicates that fund selection is a critical factor to successful fund investing.

SLIDE 8
Current Investment Opportunities

Successful private equity programs take advantage of inefficiencies in dynamic market environments.

- We believe that market volatility, regulatory changes, and fragmented markets present the following attractive, near-term investment opportunities:
  - Mobile internet buyouts
    - Funds between $200 million and $500 million in size
  - European private equity
    - Middle-market buyouts
    - Venture capital
  - Blue chip venture capital
**SLIDE 9**

**Current Investment Opportunities**

- **Middle Market Buyout**
  - Fragmented markets, opportunity to add significant value, and low purchase price multipliers present an attractive investment opportunity in the middle market
  - There is a very attractive exit environment for middle market companies

- **European Private Equity**
  - Europe's transitional market and economic and structural reforms create opportunities for private equity gains
  - Venture capital is attractive because of a dramatic growth in research centers and technology hubs, an increased emphasis on life sciences and low valuations
  - Middle market buyout is attractive as a result of loss competition, an active exit window, and consolidation of fragmented industries

- **Blue Chip Venture Capital**
  - Poor public market performance has historically meant attractive venture returns
  - Recent successes make it critical to invest with blue chip VCs that follow proven fundamental investing principles

**SLIDE 10**

**The Market for Private Equity Secondaries**

- **Self-Side Drivers**
  - Liquidity needs of LPs in difficult economic conditions
  - GP's may choose to dispose portfolio companies rather than to extend fund life or generate exits in difficult markets
  - Changes in asset allocation due to regulatory or policy requirements

- **Buy-Side Drivers**
  - Less exposure to the early, negative years of the J-curve and potentially better risk-adjusted returns
  - More asset transparency (easier to identify winners from losers)
  - Vintage year exposure and immediate diversification
  - Attractive valuations (may purchase at discounts, since sellers have liquidity needs)
  - Less sensitive to changes in the business cycle

- **Risks of Investing in Secondaries**
  - Increased competition among secondary funds
  - Danger of auctions and the “winner’s curse”
  - Complex, time-consuming transactions—secondary sales of operating companies might require a new GP to be established

**SLIDE 11**

**Secondary Supply**

Secular growth driven by new capital commitments to private equity

**SLIDE 12**

**Private Equity vs. Hedge Funds**

- The private equity asset class is markedly different from hedge funds.

<table>
<thead>
<tr>
<th>Private Equity</th>
<th>Hedge Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Longer holding periods</td>
<td>Shorter holding periods</td>
</tr>
<tr>
<td>Efficacy</td>
<td>Limited liquidity</td>
</tr>
<tr>
<td>Closer contact with operating companies</td>
<td>Investments in synthetics and securities</td>
</tr>
<tr>
<td>Investments in companies with tangible assets</td>
<td>Usually noncontrol positions</td>
</tr>
<tr>
<td>Controlling stakes are common</td>
<td>Assets traded on a public secondary market</td>
</tr>
<tr>
<td>Opportunistic advantage of inefficient markets</td>
<td>Daily net asset value</td>
</tr>
</tbody>
</table>

- Currently some hedge funds invest in private equity; causes blurring between the two asset classes
- Fundamental differences between private equity and hedge funds create opportunities for diversification

**SLIDE 13**

**The Importance of a Systematic Approach to Private Equity**

Adopting a systematic approach to private equity investing can alleviate the stress caused by market cycles.

**Top-Down Approach**
- Research-driven analysis of macroeconomic conditions
- Investment environment
- Political and regulatory factors
- Inflation and interest rate analysis
- Drivers of private equity markets

**Bottom-Up Approach**
- Comprehensive analysis of each manager and fund
- Is the manager best positioned
- Is it a sound strategy
- Is the track record as stated
- Are the advantages sustainable
- Benchmark against top-quartile peers

**SLIDE 14**

**Developing a Successful Private Equity Program**

- Determine the reasons for investing in private equity
  - Superior risk-adjusted returns should be the overriding reason for investing in private equity

- Establish an optimal asset allocation, with a suitable allocation to private equity
  - Risk tolerance and overall investment objectives should guide asset allocation

- Develop a robust framework for private equity investments
  - Selecting a suitable asset allocation among asset classes, types, size, industries, and vintage years presents a number of challenges

- Decide on approach to building a program
  - Programs require specialized resources but are traditionally constrained
  - Choice of booking internal resources or tapping external expertise

- Start implementing the program
  - Challenge is to achieve target asset allocation while selecting top-quartile fund managers
  - Take advantage of current opportunities presented by market inefficiencies
  - Need for proper accounting systems to track capital calls and distributions

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Increasing Allocation to Private Equity

Allocations to private equity have increased across pension funds and other tax-exempt institutions in Europe and North America.

Europe

North America

Resource Requirements

Successful programs require vast, specialized resources to overcome the challenges of private equity investing.
- The following key aspects of private equity investing are time and labor intensive and require investors to invest in resources before investing in private equity:
  - Deal sourcing
  - Due diligence
  - Monitoring
  - Accounting and administration
- Investing in diverse private equity asset classes requires resources that have specialized investment, geographic and industry knowledge
- The current challenging market environment has increased the amount of resources required to continuously monitor private equity portfolios

Strategies for Overcoming Resource Constraints

Resource constraints can be overcome by leveraging internal resources and aligning with firms that help make private equity investing more efficient.
- Investors have a choice of strategies while starting a private equity program:
  - Build internal resources and expertise
  - Seek third-party assistance
    - Consultants
    - Fund of funds
  - Implement a program that is a combination of the above
- Building internal resources is time, capital, and labor intensive
  - A complete complement of experience private equity investors and administrative staff is required to successfully manage a program
  - Hiring a consultant reduces the burden of building a full private equity team but still allows investors to slowly build internal expertise
  - Alignment of interests is an area of concern
- A fund of funds requires the least commitment of resources
  - A separate account enables investors to collaboratively build internal expertise

Summary

- Determining an appropriate asset allocation based on risk profile and overall investment objectives is one of the first steps to building a successful program
- A research-based top-down, bottom-up approach to private equity investing provides a robust approach to comprehensive due diligence
  - Extensive due diligence and proprietary information required for making successful investments require extensive resource commitments
- Resource challenges can be met by choosing an appropriate private equity strategy
  - Choice of building internal resources or utilizing external expertise
  - Building internal resources requires time and capital
  - Partnering with the right fund of funds is a viable strategy
- Take advantage of current opportunities presented by market inefficiencies
  - Middle market buyout
  - European private-equity
  - Blue chip venture capital
DISCUSSION
Golden, Alouf, and Masuda, moderated by Nakamura

MR. NAKAMURA: Money allocated to alternative investments in Japan is steadily increasing from 2000, and, at the end of last year, 18 percent of pension funds were invested in hedge funds. However, there were only fifteen pension funds investing in private equity. The first question is "Why private equity? What are the objectives, advantages, and broader significance?" Mr. Golden, in the case of Princeton University's endowment, what sort of objective did you have in mind when you first started investing in private equity?

MR. GOLDEN: Our objective of gaining a high return is the main reason why we invest in this area. We felt that it would make sense to take the risk if we could earn a 10 percent real return after inflation. Others often say that the reason to invest in private equity is to diversify, but I think that is overstated.

MR. NAKAMURA: Mr. Alouf, can you give us your explanation and give us some percentages for determining private equity investments?

MR. ALOUF: The current overall allocation mix for private equity is 5 percent. When we got into private equity back in 1989, the risk-return possibilities were much higher than what they are today. Our overall program's net return has been 23.7 percent since inception. If you made our existing market value $1.00, our net IRR would still be at 18 percent. Going forward, I'm hoping for net returns of 12 percent to 15 percent for venture capital for the top-quartile performers. These returns might seem low, but if you also expect the U.S. public markets to be returning about 7 percent over the same time period, then you are still outperforming the public markets.

MR. NAKAMURA: Mr. Masuda, can you tell us your thoughts on why pension funds in Japan should invest in private equity?

MR. MASUDA: Well, I do think that in the current environment, there's more to gain from the stock market than private equity because the risk premium on equities is coming down. However, top-line growth can be attained through private equity, and, even though there are differences among managers, that would be the main reason to incorporate private equity into the portfolio. Also, when setting up a private equity program, Japanese investors have to think globally. Otherwise, this asset class will probably not see success.

MR. GOLDEN: When I mentioned return prospects earlier, I was talking in dollar terms. Japanese investors should think about whether now is a good time to enter this market. The duration of private equity investments is very long, so it would be impossible to effectively hedge the risks of deploying yen right now as dollars. I am also continuing to invest in the United States, not because we'll earn anything like those returns going forward for the next several years, but only to maintain relationships for when times are good. So I do not know why anyone would start new relationships now. I would wait until there's so much pain from investors and they flee certain managers. That's when you can start a relationship. One source of return is entering at low valuations. Outside the United States, we have been inhibited from investing with private equity managers in many cases because they don't set a high enough bar.

MR. NAKAMURA: Mr. Alouf, what kind of process did you go through in the very beginning of VRS's private equity program? What did you examine, how did you develop internal resources, and so forth?

MR. ALOUF: Regarding asset allocation, we were victims of the Internet bubble, and when venture capital funds started doubling in size in a very frenetic pace, we did not take our pro rata allocation. Instead of investing say $20, $40, or $80 million, we stayed at $20 million. So that was a very fortunate discipline, since we thought the pace was way too fast. However, we are paying the price for that now, since managers are coming back with funds half the size. So there is a lot of discussion as to why we should be allowed to increase our pro rata allocation from a prior fund. Also, we don't purport that we can always find top-quartile managers since only one out of four is going to...
be in the top quartile. We looked back at our performance and found that only two-thirds of our managers are first or second quartile performers. The reason our returns are so outsized is because we really chose the correct top quartile manager, meaning the one that really outperformed.

As far as developing a program, we have seventy different general partners and we have three investment professionals managing those relationships and looking for new deals. What we are doing now is to try and find the best new talent out there by using an adviser to help us out with what we call smaller or emerging managers.

**MR. NAKAMURA:** Mr. Golden, in terms of internal resources and set up, how did Princeton increase private equity investments and resources?

**MR. GOLDEN:** We take a bottom-up approach, so we have increased our commitments opportunistically. It just so happens that we found a number of great managers this year and last year, but next year it may be much smaller. In terms of staff, we have grown very slowly. One might think that our growth pattern ties directly into our ability to find top quartile managers. Going forward, I do not believe the top quartile will be good enough to make an attractive program. There are so many more managers out there but there can only be so many great venture capital and buyout firms. Yet the number of total firms seems limitless, which is another reason we should all be cautious.

**MR. NAKAMURA:** For Japanese pension funds thinking about funds of funds, what should they look for?

**MR. MASUDA:** Normally there is a minimum commitment of $5 to $20 million, and I believe fund of fund managers have direct access to certain types of assets. That usually means the fund is more globally balanced. But you have to be careful of fund of funds as well. You have to determine what the target, or investment, is. Does it match your need? You should meet as many managers as you can, since there’s a huge difference from one to another. Also, if you think the fund of funds is too large, then you can set up your own relationship in buyouts and choose a particular emerging manager.

**MR. ALOUF:** One thing to be careful about is when a fund of funds tells you to put more money into the market. You’re either taking a bigger investment with larger funds, or you’re creating an index type of fund. Be careful of the growth and assets of the fund of fund. Once they become an index fund, or if they start putting large amounts of capital into the biggest funds, your returns are not going to be very attractive.

**MR. NAKAMURA:** Mr. Golden, what’s your view about the use of the secondary market when establishing a private equity program?

**MR. GOLDEN:** We occasionally buy in the secondary market as a way of augmenting a relationship, but for those just starting out, they would need to hire a specialist. There is another layer of fees and conflicting interests for the fund of fund to deploy more assets. I think there is some adverse selection in the secondary market so one needs to be very selective because if funds are really good, then you wonder why the limited partnership of the fund is in need of liquidity. So, in general, I’m quite skeptical.

**MR. ALOUF:** If you are entering the private equity world and you want to make a substantial investment quickly, use a secondary purchase and get a nice bit of vintage year diversification. I think there are pockets of opportunity in secondaries. However, the larger the position, the less return potential you have. One thing we are looking at right now is to possibly sell some funds that are basically reaching the end of their life just to get it off our books. However, private equity is all about relationships, so if you’re flipping something, over the short term that might be okay, but as far as establishing long-term relationships, that won’t help you.

**MR. NAKAMURA:** How do you evaluate Japanese companies in terms of venture capital or buyouts?

**MR. ALOUF:** We have not made any investments in Japanese or Asian private equity. Our allocation to Western Europe is only 18 percent, and we’re expanding a little there. I only have a staff of three, overseeing $7
billion. About 82 percent of the investment is in the United States, so my team is too busy to come over here. I think there’s probably a lot of opportunity here that I don’t know about. However, from a time perspective, I don’t know if that’s worth the return opportunity. If we do look at Japan or Asia, it will probably be through a fund of fund, someone that has experience and exposure in the markets. I was talking to a fund of funds manager who had invested in Japan ten years ago, and he told me now was the time to get into the market.

**MR. GOLDEN:** Our investment in Japan will depend on two factors. One is the availability of top-quality private equity investors to partner with and, second, the ability for these private equity managers to improve fundamental value at companies. That would seem to be dependent on being able to restructure many of the companies that present the best opportunities. However, how can one restructure a company to the advantage of shareholders while still maintaining promises to all stakeholders? This is why private equity investing in Japan has been less attractive in the past than elsewhere.
PART II: BANK AND INSURANCE COMPANY ROUNDTABLE ON PRIVATE EQUITY

MODERATOR
Mark Mason, Columbia Business School

PANELISTS
Andrew Golden, Princeton University Investment Company
John Alouf, Virginia Retirement System

THEMES
Portfolio Valuation
Manager Selection
Fund Monitoring and Performance

Panel I: Portfolio Valuation

DR. MASON: Welcome to this second Japan Roundtable on Alternative Investments for the Japanese banking and insurance communities. I would like to launch immediately into our discussion and start with a consideration of portfolio valuation. Andy, what is Princo’s approach to valuing its private equity portfolio?

MR. GOLDEN: Valuing a private equity portfolio is very, very hard. It’s more art than science. For us, we start with numbers provided by the general partner, and most of the time, we’ll adjust them downward. As many of you may know, the general partners have a wide berth when valuing portfolios. There are more standards in venture capital than in the buyout world. Venture capital tends to be held at cost or less, until there’s some verifiable, or additional, financing that comes in at a higher valuation. That’s only written up if it involves an outside party, and sometimes the valuation is not written up all the way. In fact, only half of it is written up if that new party is a strategic, rather than financial, inventory. Of course, a venture capitalist will write down a company’s valuation if there’s good reason to consider the company impaired.

In the buyout world, there’s less of a standard. Some buyout managers hold at lower cost or a lesser value if there’s been some impairment. Others will compare to similar companies. But the key question should be why we should care what the value of the portfolio is at any given moment. That may sound odd, but ultimately we find out what the value is when the portfolio companies are liquidated. Much more often than not, portfolio companies have been liquidated at a higher value than what they were being held at.

It is quite uncomfortable to not know exactly what your portfolio is worth. However, history and theory show that investors get rewarded for discomfort. They should get rewarded; otherwise there would be no reason to do uncomfortable things. I think that we can contrast this to public markets, where I think there is an illusion of knowing how much your portfolio is worth. You get great precision but maybe not accuracy. My support for that outrageous statement is when one looks at the volatility in the public market, it is hard to believe that the true economic value of a company is as volatile as its share price. The decision is largely made on qualitative factors and understanding what is going on with the companies and partnerships. That’s based as much on qualitative issues as it is on quantitative analysis.

MR. ALOUF: I’ll break down valuations into two pieces: what I encourage the managers to do and how I value a
portfolio when looking at a potential investment opportunity. I prefer not to be surprised with anything on the downside. I encourage my managers to keep things at cost. On the venture side, the write-ups are okay if you have another round of financing with an independent third party validating the new valuation or with the sale of the company. On the buyout side, once again, I prefer that they be held at cost. I would rather surprise investors on the upside. How do I look at valuations when I’m looking at a new opportunity? On the venture side, how do you value a business that has no earnings? They can tell me about a new opportunity that sounds like a great market. However, I don’t know how many other players are out there feeding on the exact same market. A rule of thumb that a lot of people have talked about is in the Internet bubble, when companies were talking valuations in the billions. A lot of software companies today talk about exit valuations of no more than $200 million. So if you’re looking for the amount of capital a venture group is putting into a software business, I don’t want to see them get overvalued with putting more than $20 million in because these are still risky investments. If you don’t have the opportunity to make ten times your money, I prefer not to see them doing it. I believe the venture market has gotten a lot more conservative in the pricing they’re paying for businesses. On the buyout side, I look at the growth of earnings, as well as the debt level of the business. A big trend in the U.S. buyout market during the past year was recapitalizations. “Recaps” don’t get a gold star from my managers or me, since private equity is about creating value. Recaps don’t create value; all it is is utilizing an aggressive debt market.

**DISCUSSION**

**AUDIENCE:** There are a lot of buyout firms that recapitalized deals last year to the limited partnerships, but they still hold all the equities at the same valuation as before the recapitalizations. In this case, do you encourage the general partner to invest in a conservative way?

**MR. ALOUF:** The current situation is like revisiting 1998, when purchase prices and debt levels started going up. The difference between 1998 and today is that the rates that they’re paying on the debt are much lower. In 1998, you were looking more at debt multiples, but now, even if the multiple still might be high on the earnings that you’re paying, you need to look at the interest expense that is being paid. It is nice to have the recap to get the money back, but then I get worried about how much leverage is being put on the business and what happens when there’s a hiccup in the economy. The good thing about this environment is that the rates they are paying are lower. However, as far as creating value, I don’t view that as a positive move by the manager because anybody can do that. You’re not differentiating yourself from the pack.

**MR. GOLDEN:** I am a little bit less concerned about recapitalization. I think like many things in investing, it depends on the facts and circumstances, but leverage doesn’t kill companies. Bad use of leverage kills companies. So I think in some cases it’s a very smart thing to do. It’s less probable that recaps are a source that adds value unless you are very good at knowing how to do it. It’s definitely not the same as improving the fundamentals of a company.

**AUDIENCE:** For a small operation, how do you delegate who does what? Some people in my group are afraid of making decisions because private equity investments are so long term and you never know what’s going to happen.

**MR. GOLDEN:** I have fifteen colleagues, three of whom are very senior colleagues. I consider them my partners, and those three are each responsible for leading an effort in one or more asset categories. Everyone below that is really kept more as a generalist and works across different asset categories. The decisions are processed with a team approach, and we try to build a consensus. The three senior colleagues and myself are called managing directors, and we lead the effort to get a consensus. But we all get to vote. It’s important to understand that all of us are compensated on how well the overall fund does and not on how well individual asset categories or investments did.
Our board has many important responsibilities, including whether or not to change staff. One way we get around the difficulties of evaluating a private equity portfolio is by understanding the process used. We work very hard to practice what we preach, or the importance of qualitative factors in evaluating managers. So we supply our board with investment memos that explain in advance what our thinking is. We have the authority to hire and fire outside managers, but we write memos reporting our thoughts on why we did something.

**AUDIENCE:** Does that cause a problem if one investment turned out to be a failure?

**MR. GOLDEN:** I wish only one investment turned out to be a failure. Investing is like backgammon, not chess. There’s luck involved. There are dice that get thrown, and part of the motivation behind focusing on the entire endowment rather than on segments of it is a thing like compensation. The more plays involved, the more individual decisions that we can bundle up, the more we can diversify. We expect many of our investments to turn out badly. Some will be because of bad decisions. Others will be because the dice came up the wrong way, but you cannot invest in these areas if you are frightened of failure.

**MR. ALOUF:** That’s one of the tough things with private equity. You’re reminded of the investment decision again and again and again until the ten-year time horizon is up and hopefully the manager will be liquidating on time. We have had situations where investments have not turned out well. If the investment decisions were poor, that’s one thing. But when you have managers that are acting not in the LP’s best interest and are out to benefit only themselves, they hold on to these portfolio companies and won’t sell them to eke out extra management fees. That becomes a real issue. To deal with this in court, you need a 75 percent vote to dissolve the partnership and that’s very difficult to get and extremely time consuming. I went through this a couple of years ago, and I’m going through it right now. It’s very frustrating. This is one of the negative aspects you have to be prepared to deal with.

**DR. MASON:** Can you give us some sense of the composition and character of your boards? In particular, how well do they understand alternative investing in general and private equity investing in particular? We’ve noted that there are often a range of successful high-net-worth individuals on the boards of many U.S. endowments who themselves have been very active in, for example, hedge fund investing.

**MR. GOLDEN:** There are nine outside directors on the board, four of whom are involved in investing professionally. We do have two investment bankers, but I don’t know if they qualify as investors. The chairman of my board is a founder of one of the longest-standing venture capital firms in Silicon Valley, so he “gets” venture capital. Another member is a venture capitalist with one of the oldest venture capital firms. He “gets” it. Another board member runs a fund of hedge funds professionally. He “gets” it. Another board member runs one of the largest family offices. She “gets” it. The dialogue is much easier. The secret, I think, to success is having smart bosses.

**DR. MASON:** Is it safe to say that some of those board members also help you get access to quality private equity funds?

**MR. GOLDEN:** It is the case. It is hard to separate out the results of individual board members as opposed to the combined Princeton force.

**MR. ALOUF:** I’m very envious. The board at VRS is made up of state employees. They’re teachers, policemen, firemen, and the like. The board is advised by our investment advisory committee, and our investment advisory committee is made up of industry practitioners. They’re professors and people that are knowledgeable about the markets. They aren’t usually private equity professionals or hedge funds professionals, but it will be people that have run pension funds before, people that are currently chief investment officers. I believe there are eight or nine people on our investment advisory committee. We use them as a sounding board and don’t tell them what we do one way or the other. We don’t have to ask for their permission. We tell them this is our plan, do you think this is reasonable, and they’ll report their findings to the board and then their board signs off if what we’re doing is okay.
Panel II: Manager Selection

DR. MASON: I’d like to move on to the theme of manager selection. John, how do you pick private equity managers to invest in?

MR. ALOUF: We look at countless opportunities. Our basic process usually starts off with a meeting at VRS. I try to limit the meeting to one hour because we meet so many different groups. After that I’ll go back, usually make a few phone calls to people that I know that are potential investors, have invested in the companies, or someone that is co-invested with the group to see if it sounds like a decent opportunity.

If the phone calls work out okay, it’s a trip to see the manager. I usually spend half a day to a day in their offices getting a very thorough look at their process and their track record, realized and unrealized. Then we come back. That’s when the real due diligence kicks in, with making many, many phone calls to many different people. Experience helps since as your network grows, the due diligence you’re able to do becomes more thorough. So after due diligence is done, it requires writing an investment recommendation. I let the CIO know there’s a pending recommendation coming her way. We submit a recommendation. The CIO, the Director, the Deputy CIO, and our Chief Operating Officer read the recommendation, and they basically approve or do not approve the investment recommendation.

However, for the entire five-plus years that I’ve been at VRS, they have never turned down an investment that we have proposed. As long as we can answer the tough questions, [the CIO] is okay with our investments. Each time I go to [the CIO], I do not assume that she’s going to approve a recommendation, though. I make sure I have all my boxes checked and all my thoughts about what she might be asking.

What are the key features I look at when analyzing someone? First, I look at the track record. You can’t lie about realized numbers. I then look at developments in the unrealized portfolio. I look at the growth, market share, and debt levels. I also take a look at what the proposition was, what the manager’s thoughts were going in, and how that has worked out down the road. A big thing for me is the manager’s reputation that I hear from different references. And it’s not just about their ability, but their integrity. When you’re locked up for ten years with someone, you want to make sure that you trust a manager and believe he/she has a lot of integrity. I also look at deal flow. Do they have a different angle? Do they have an expertise in a specific area? I also look at the market in which they compete. Do they have a leg up on the competition? I look at their strategy. I look at their process, and I also look at how they’re able to add value to portfolio companies.

MR. GOLDEN: Our process is labor intensive. For a new manager to get hired, we spend more than four hundred hours before signing a contract. I personally spend about twenty. I’m less thrilled about this role, but I also act as a salesman. This is growing more and more important, since getting access to the best managers is quite hard. It’s important that we go to their office and show them how important they are going to be to us. This is, in fact, why I was in China. I was there to sell Princeton to managers, but also to get firsthand understanding of something very unfamiliar.

We look for a manager’s ability to create fundamental value. So in addition to making calls, talking to other managers, and checking with investors about someone’s reputation, we also spend a lot of time talking to portfolio company management to understand how the private equity manager has been engaged and what success the manager had in helping executives make the company better.

AUDIENCE: In Japan, it’s more like getting selected by a top-tier manager than the investor selecting them. As an investor, what can you do to be a better candidate to be picked?

MR. GOLDEN: I’ve been doing a lot of work on hedge funds, and I can tell you their selection is certainly a two-way street. And I think it’s the same in private equity. Essentially, all sales involve listening to what the customer
needs and wants and explaining how you can fulfill those needs and wants. I think that’s what the best managers are looking for. For us, the prestige of Princeton makes my sales job a lot easier. But other elements involve action. We try to convince the manager about what we won’t do to them, hope our conversations are stimulating and are about important issues, and that we’re not a waste of their time. We can also demonstrate that there’s a long list of other managers that we can use as a reference. It’s important to make connections, advise them on elements of their business. This is more for emerging firms, but that reputation of being a giver and not just a taker makes us attractive to some managers.

**MR. ALOUF:** As state pension funds go, VRS is very well regarded. We are one of the first in the industry to really take hold of hedge funds. We’ve been in it since 1989, so we’ve proven we’re a long-term investor. We have a very easy process for a state pension fund. You don’t have to come visit our board, nor do you have to give a presentation. When you want a closing, you don’t have to wait for some sort of meeting.

I agree that it’s a two-way street. The manager is pitching himself to us, and I, at the same time, am pitching VRS to him. We try to be proactive. I always ask managers about whom they see that are out there that they really respect. Who’s in the deals with you, and who looks at the world the same way you do. Since there are so many different venture and buyout funds out there, we try to call the ones coming out to the market three or six months before they go public. I’ve got this speech I give. “I’m sorry, we have to write big checks, but we are a long-term investor. We really like your story. We’ve done research on you,” I say. You need to show that you’ve done the background work before you meet with them. You need to get in front of the managers before they start getting a lot of investor interest.

Another thing that I’ve done is to form relationships with placement agents. Now, you may ask why a good fund would use a placement agent to raise funds. Sometimes they want to diversify their client base. They’re three times oversubscribed and need to hire a placement agent to weed the investors out. This has worked a few times for us in Europe, and because of the relationship I had with the agent, I knew what was coming down the pipeline. That’s when you can be a little bit more proactive and get in front.

**AUDIENCE:** Do you try to have a specific number of new managers you hope to work with at the start of the investment year?

**MR. GOLDEN:** No, we do everything bottom up. It makes no sense to predetermine what you’re going to do either in terms of numbers of relationships or funds deployed. To do that would be risky, forcing money to work in suboptimal funds, or arbitrarily taking a smaller amount, or passing on very good funds because they had the misfortune to show up during a year that was crowded.

**MR. ALOUF:** Since our venture allocation is 18 percent, I’m not going to stretch that to fill up a bucket just so I have an allocation of venture capital. For example, we have six deals closing in March. Six! Since we only have three people, I’ve had to adjust our schedule about looking into new opportunities. Basically we can’t look at new deals until June. The last thing I want to do is shortchange my due diligence process so that I can put in a new manager.
Panel III: Fund Monitoring and Performance Measurement

DR. MASON: Let’s now turn to fund monitoring and performance measurement. Andy, what is the approach at Princo?

MR. GOLDEN: Fund monitoring is labor intensive. We spend between six and twelve days for each active relationship we have per year, and I’m not including travel or back-office time. I’m also not including portfolio overhead or the monitoring of the collection as opposed to the individual elements. I think “monitoring” is perhaps the wrong word. What we’re really trying to do is to help the manager, as well as keep an eye on things.

One element that’s important in this monitoring process is that we typically serve on advisory committees or boards for each manager, which creates a very natural way of spending time together. Sometimes we help the manager think about their business. Not every manager wants advice, but it’s just a very effective way of building consensus around what the manager has already decided. We can also be helpful in acting as a conduit for managers to get to know each other. This is most notable with connecting domestic managers with foreign managers.

On the question of measuring performance, I think many times the question and answer is more complicated than it appears. We don’t get too tied up in the quantitative, but focus on qualitative assessment. Often when we have to make the decision to invest in the next fund, it’s really more a question of the fundamentals of the company than what might be stated as the performance to date.

How can I be this confident when it seems so hard to measure performance? Experience has taught me that things tend to work out even better than estimated. A little leap of faith is often rewarded.

MR. ALOUF: I spend between 75 percent to 80 percent of my time looking at new opportunities, because our investments are over a ten-year period. Once I’m in, I’m stuck with them. So I better make sure that I’ve made a very thorough and thoughtful judgment.

How do we monitor funds? In my mandate, I have to visit the manager at least once a year. I like to visit more, but I can’t. I naturally have a better rapport with some managers than others. I also try to make sure I at least have several conversations through the year in addition to my visit, but there are other managers that I talk to once a month. Usually the ones I talk to once a month are not the largest. I get a lot of value from the middle-market guys.

A lot of my fund monitoring is also for an upcoming fund: what are the developments in the partnership, how are the existing investments going, and what’s the state of the market? You must get a good feel for the manager. How do they articulate their strategy, and how has it evolved based on how the environment has changed? I like contrasting what different managers say about the market and how they’ve reacted to it. I also use my existing managers to source new deals through someone that they respect in the industry.

To measure the performance of private equity investments, you can look at IRRs and capital return. I don’t want to see 100 percent or 200 percent IRR and get my money back in four months, but at the same time, I don’t want to see a deal that has a multiple of four over fifteen years. One of the most difficult questions to answer is how to evaluate the performance of a venture capital manager because of the Internet bubble. Is the outsized performance the manager had from 1996 to 1998 due to them or due to the market? Is their negative performance between 2000 and 2003 them or the market? How much incentive does the manager have to work as hard as he did in the past?

I also don’t try and make an adjustment to the market values of my managers at the end of a quarter and think the value should be X or Y. However, when I am looking at a manager to determine if I want to do a re-up, that’s when I’ll go ahead and do the adjustments myself.

DR. MASON: Let’s open up the discussion to some of the Japanese participants who have invested in private equity so they can compare their experiences and approaches.

AUDIENCE: For my firm in Japan, about two-thirds of the funds we invest in are offshore. So it’s very difficult to
meet managers once a year. We try to visit them during
the annual meeting of these funds when it’s at all possi-
ble. Does it make a difference when you see a manager,
whether it’s at the annual meeting or in a separate visit?

**MR. GOLDEN:** I think annual meetings are often a waste
time.

**MR. ALOUF:** You do receive a lot of overview materials
at annual meetings, but you don’t get to hear exactly what
your hot button issues are or your concerns. However, a
lot of times annual meetings are a good way to develop
other questions. I enjoy portfolio company presentations
to watch developments. In addition, there are other limited
partners that are there, and I bounce thoughts and ideas
off of them. Also, I do get to meet the lower level staff
that generally I don’t get a lot of exposure to. I think this
is the key to finding out the quality of the troops behind
the big names. This could be the opportunity to meet
someone who could be a new manager down the road.
Also, a lot of times I found that when you talk to the gen-
eral partners, they’re pretty rehearsed and they know
exactly how to answer your question. The farther you go
down in the ranks, the less polished they are, and the
more information they’ll share with you.

I do find value in the annual meetings, but if you
want to ask certain questions, you can get your answers
a lot quicker through a face-to-face meeting.

**AUDIENCE:** Sure, sometimes I get confused by these
annual meetings held at posh resorts. What exactly is the
objective? But I like attending them because we can net-
work with other limited partners. That’s a bigger, more
important value. Sometimes they give us names of fund
managers that we weren’t aware of and that is helpful. So
I can’t say it’s a total waste of time.

**AUDIENCE:** Disclosure from managers is a tough thing in
Japan. There aren’t enough laws in Japan that require dis-
closure, so we try to pick a manager that is willing to
share information. The U.S. Freedom of Information Act
(FOIA) got a lot of press coverage for a while, but it has
died down. What is the situation right now about this law?

**MR. ALOUF:** FOIA is still a hot issue, but it has calmed
down. FOIA is why VRS is trying to be a proactive limited
partner. When we first heard that the FOIA would require
us to disclose our portfolio company data, we said, “Look.
We have great brand-name private equity firms we’ve
invested in, and if we start divulging portfolio company
data, we basically have wasted this great network.”

We boxed up every quarterly and annual report from
our different general partners, and we shipped them to
the managers. We asked them to ship it back to us when
nobody was asking for that information. That went a long
way. Secondly, we worked very hard and actually got an
exemption from the legislature. The wording wasn’t
exactly what we wanted, so we then went to the Attorney
General and got an additional opinion that states that we
do not need to provide portfolio company data.

VRS tries to stay out of the news. I just like to sit back
and mind my own business. That makes my life easier. So
far, the FOIA issue has not been a reason as to why we
weren’t able to invest with any of our top-tier managers.

**DR. MASON:** I heard that CALPers tried to create a buffer
company between themselves and some of the funds
they’re in so that the buffer company would receive all
the primary information instead of CALPers. The pension
manager would then ask questions to this buffer company
as needed. In this way, CALPers reasoned that if they
were sued for disclosure, they could truthfully deny
having possession of the information. But I don’t think
that’s a common practice.

**AUDIENCE:** I find it very difficult to monitor venture cap-
ital funds, especially the ones that invest in IT and
biotechnology. I can’t keep up with all the new inven-
tions, gadgets, and lingo because by the time I understand
it, it’s old.

**MR. ALOUF:** I completely agree with you. When I first
started at VRS, I told myself that I was going to under-
stand technology and biotech. But I realized that by the
time I read about something in the industry journals, the
material was outdated.
I think some of the venture managers that are really honest, a lot of times they don’t know about these new technologies either. They often hear about it from the portfolio companies, other entrepreneurs, or venture partners that are really closer to the street. The fact is, when you have a large company looking to buy a new product, do you want to buy it from this small venture company that might not be around tomorrow, or do you want to buy it from an established player where the product might not be as beneficial? Do you want to be the guinea pig or the first client that takes on the beta risk? There are a lot of good companies that don’t make it because it’s hard to get these new companies to buy things. In addition, many chief technology officers are cutting back on their staff. It’s getting harder today for a venture-backed company to make it.

One way I look at some venture firms is to look at the companies they’ve spawned in the past. Are these companies still viable or still around? Many times, success breeds success. As one successful company is created, there will be two or three spinouts from there.
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