HARBOUR CAPITAL ADVISORS

Vintage Year Diversification in Private Equity Investing

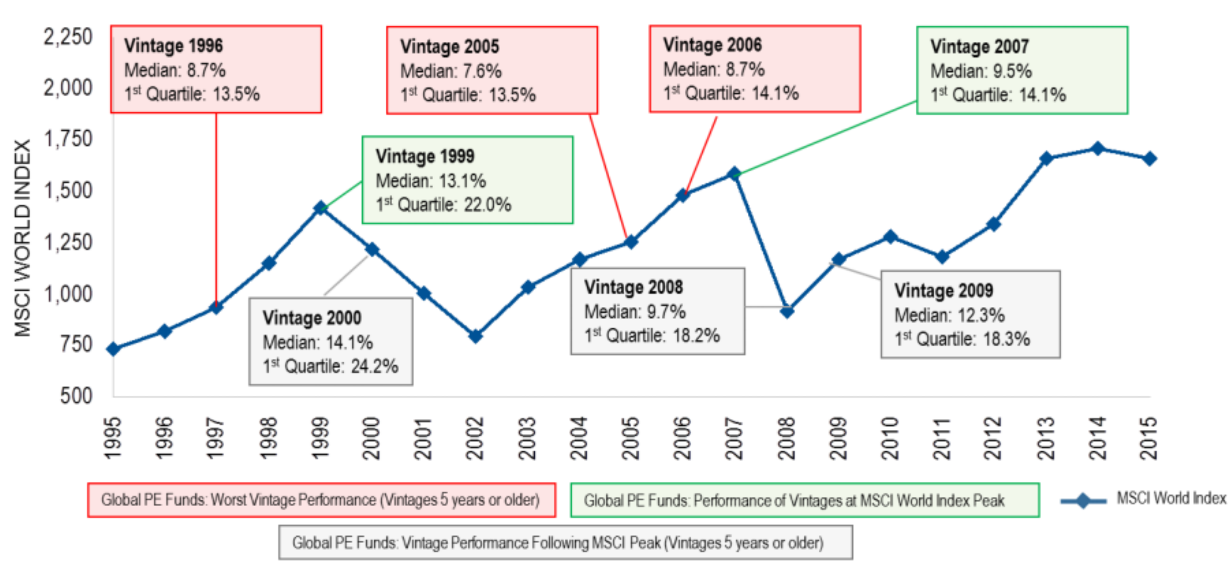
Investors have long looked to private equity investments as a potential source of more attractive returns and low correlation to other asset classes, helping them achieve diversification from public markets. A typical private equity fund has an initial duration of 10-12 years. This can be segmented into an investment period during which capital is called and put to work (typically the first five years), and a subsequent harvesting period during which the fund looks to exit already existing investments and return capital to limited partners.

The ‘vintage year’ of a private equity vehicle refers to the year in which the initial influx of capital is first delivered to a project or investment. The vintage year of a fund, and the phase of the business cycle in which the vintage year occurred, is highly determinative of the performance outcome realized by the fund.

For example, a fund with vintage year at a trough in the business cycle will typically see a greater supply of distressed assets in which they can invest, which may, in turn, allow it to see greater returns, all else being equal. At the same time, funds with an investment period occurring during a peak in the business cycle will see a smaller supply of distressed assets, creating a drag on returns.

The business cycle has a similar impact upon the ability of a private equity fund to exit and monetize existing investments. Given that the harvesting period generally occurs well after the vintage year, a fund that began making investments at a trough in the business cycle will typically find market conditions to be more favorable as they eventually begin to divest of those assets, improving the fund’s ability to exit the investment at an optimal valuation. The opposite is generally true for funds which first put capital to work at peaks in the business cycle.

MSCI WORLD INDEX VS PRIVATE EQUITY VINTAGES



Source: Neuberger Berman

Over the past 20 years, we have seen numerous peaks and troughs in the performance of the typical private equity fund moving from one vintage year to the next. The cyclical nature of these fluctuations suggests that variability in market conditions across those vintage years has had a significant impact upon realized returns. While private equity as an asset class has historically provided strong returns relative to public equity vehicles over *full market cycles*, typical returns will vary significantly across vintage year. Furthermore, given the long-term nature of a private equity investment, realized performance of a fund will not be apparent until years later. Thus, diversification across multiple vintage years is crucial to help ensure that a broader portfolio of private equity investments more accurately represents the return profile of the asset class as a whole.

A widely-used example to capture this concept is that of a wine collector. While stocking one's cellar with wine from critically acclaimed producers is crucial to developing a superior wine collection, external factors like weather and soil conditions have a strong effect on the quality of the final product from year to year. Similarly, investing with well-regarded private equity managers who have deep skills, resources and industry expertise is key to achieving strong performance. However, shifting market conditions on a global and local level will also impact the success of a fund from any given vintage year, and the importance of diversifying private equity investments across multiple vintage years cannot be understated.

Recently, 'access fund' structures have enabled high-net-worth individuals and money managers to invest in private equity vehicles at substantially reduced minimum commitment levels. While this carries a second fee level paid to the access fund manager (in addition to that paid to the actual private equity fund manager), it has also made it easier to diversify across vintage year for investors unwilling or unable to commit relatively large sums of capital to one single investment.