Private Equity Partners | market update

January 2006

Private Equity Partners Status Update

PEP II is progressing nicely. We are in the process of completing our final fund commitments for it. We anticipate launching PEP III shortly and are beginning to reserve allocations for it. We also are happy to report that it will contain several warehoused commitments to top tier VC and LBO funds prior to launch. Please contact Gretchen Postula if you would like a draft presentation book sent to you immediately for PEP III.

Quantifiable Benefits of a Fund of Funds

Fund of funds managers are now contributing more than 10% of the capital to venture and buyout funds. Funds of funds are popular vehicles for many small and mid-sized institutional investors primarily because they provide (1) access to top tier managers, (2) professional selection expertise, and (3) diversification across multiple managers to reduce risk of loss. However, these three elements largely were evaluated based on subjective factors and intuition. While information is still hard to obtain throughout the private equity industry, several scholarly attempts have been made recently to at least start to quantify the third factor—diversification benefits.

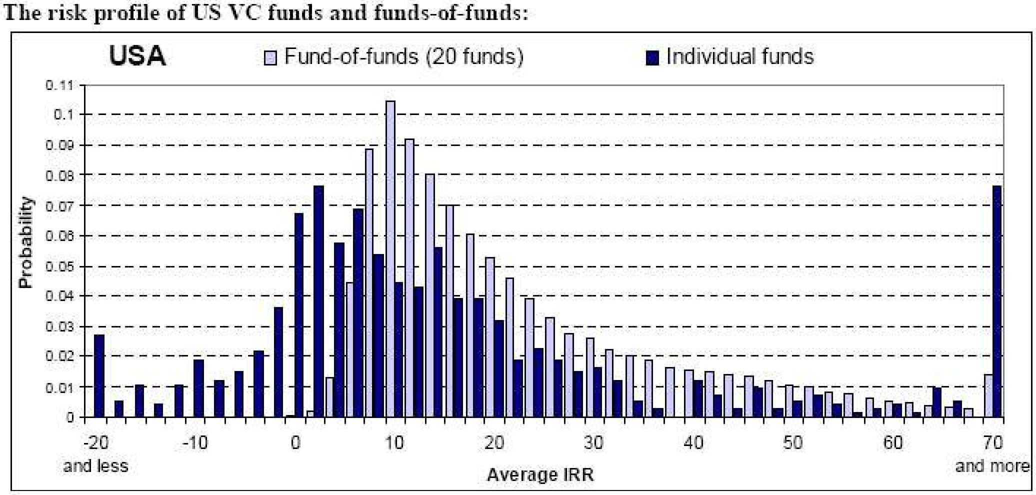
One recent noteworthy study was done by Bjoern Born, Tom Weidig and Andreas Kemmerer,[1] and we would like to share a few of their findings. Their results were based on Monte Carlo simulations. For brevity, we can only share part of the results, but essentially they created simulated funds of funds based on randomly selecting 20 underlying managers over a period of five years (i.e., four funds per year). By creating a large number of such funds of funds (e.g., 1,000), patterns start to emerge and conclusions can be drawn. For the record, their results did not factor in the ability of a fund of funds manager to limit selections to top tier firms or otherwise pick "better than average" managers so the study should be understating the benefits of a fund of funds manager. Nevertheless, the data was still instructive.

	Venture Capital		Leveraged Buyout	
US-based Funds[1]	Individual Funds	Fund of Funds	Individual Funds	Fund of Funds
Mean IRR	21.3	21.4	10.8	15.3
Median IRR	8.7	16.1	8.5	14.0
Standard Deviation	54.6	15.6	26.2	7.7

The table shows that both the mean and median returns are better for a fund of funds, and the returns are more tightly grouped together (so there is less risk as measured by standard deviation) for the fund of funds returns.

Shown another way[1]:

The risk profile of US VC funds and funds-of-funds:



Private Equity Partners

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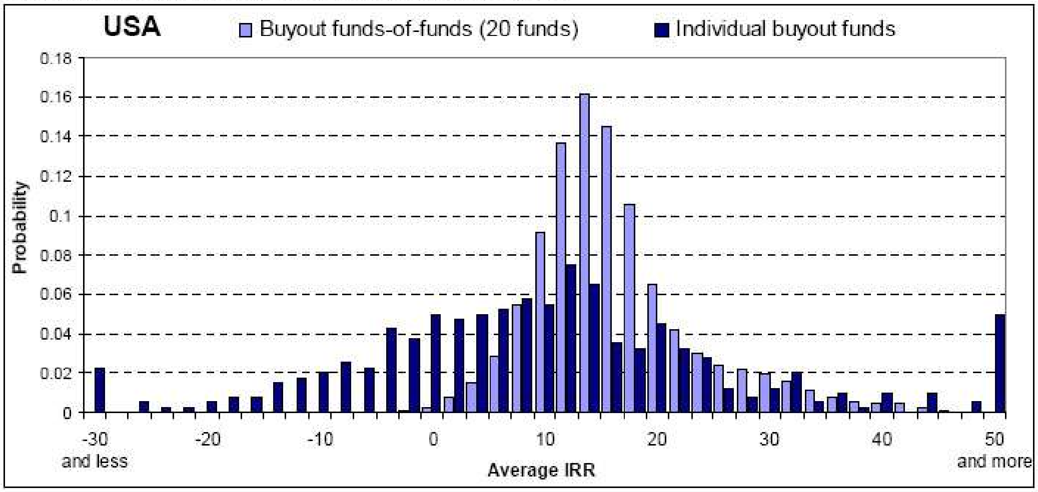
The risk profile of US buyout funds and funds-of-funds:



Conclusion

Unfortunately, this study does not contemplate the entire range of diversification parameters so we cannot yet determine the optimal amount of fund manager and vintage year diversification, but the data does empirically demonstrate the diversification benefits of a fund of funds. While intuitively we all would believe that a fund of funds would produce higher returns per unit of risk than selecting an individual fund, we were happy to see supporting data in this rigorous academic study.

This data also suggests that by randomly picking 20 US venture funds over a five year period, there is a negligible chance of generating a negative return. Diversification in this same random manner provides similar results for a buyout fund of funds—approximately a 2% probability of a negative return. This is a powerful conclusion when compared to the wide dispersion of returns that might result from selecting an individual fund manager (which 22% of the time provides a negative return according to this data). As last month's commentary demonstrated, there is a persistence for top fund managers to continue generating strong results. So taken all together, we believe a fund of funds manager who selects a diversified group of top tier fund managers, should be able to do even better than the random "simulated" fund of funds results in this study.

We are continuing to work with the academic community and our limited partners to further refine our diversification strategy as it pertains to the number of underlying fund managers and the appropriate amount of vintage year diversification. In fact, we are currently reviewing preliminary data from Mr. Born to this effect. We thank Mr. Born for his assistance with this article.

[1] Weidig, Tom; Kemmerer, Andreas; and Born, Bjoern; "The Risk Profile of Private Equity Fund-of-Funds." Journal of Alternative Investments, Vol. 7, No. 4, pp. 33-41, 2005 (http://ssrn.com/abstract=676052).

Piper Jaffray was established in 1895 and has grown to become a nationally and internationally recognized firm serving growth companies and growth company investors. We have a significant commitment to alternative assets through our series of fund of funds, ***Private Equity Partners****, and anticipate offering our next fund,* ***Private Equity Partners III,*** *in early 2006.*