

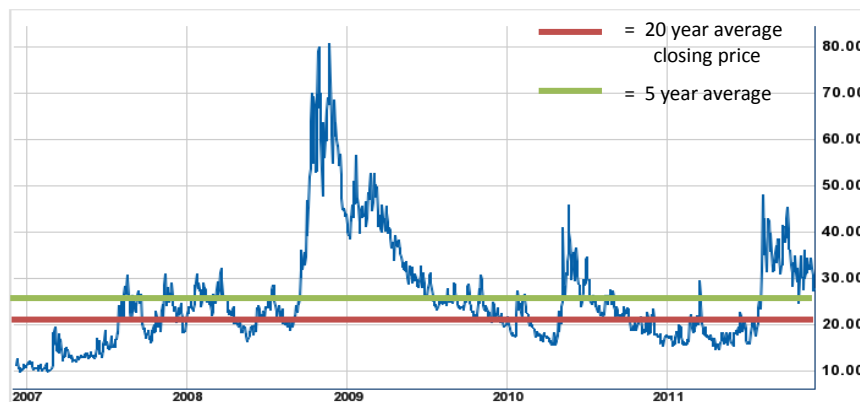
MARKET UPDATE

Volatility and Illiquidity

We wanted to touch upon two areas of investor anxiety this quarter: volatility and illiquidity. Both issues are age-old but have been top of mind for many investors since late 2008.

Volatility. Public market volatility has many investors believing this is a trader's market and that long-term holders are not being properly rewarded anymore. Over the last few years, the public equity and debt markets have had head-snapping ups and downs due to macro uncertainties created by the credit crisis and U.S. and European government debt problems, among others. For example, the S&P 500 closing price has been at least 2% higher or lower than the previous day's closing price 32 times so far in 2011 (79 times if a 1% threshold is used). For a comparison, the S&P 500 had daily volatility shifts of over 2% only twice during 2004-06. Further, it has been down a total of 107 days this year—46% of the time. Volatility, as demonstrated by the VIX index below, has been extraordinary the last five years.

(VIX) VOLATILITY S&P 500



(source: <http://www.cboe.com/DelayedQuote/AdvChart.aspx>)

It is interesting that after truly big news is announced, trading on even the tiniest bit of related news (weekly employment data, housing starts, the latest length of Angela Merkel's hemline) has been so emotionally charged, so short-term in nature and so forceful of late. Why? Because we live in an increasingly interconnected global economy with 24/7 news and possess the technology to trade more quickly and cheaply in high volumes than ever before through online brokers, high-frequency trading funds and leveraged ETFs. High frequency trading ("HFT") came into prominence about five years ago, accounting for 26% of U.S. market trades in 2006, according to Tabb Group LLC. HFT now regularly accounts for 50-70% of U.S. trading volume. HFT made up a staggering 75% of U.S. trading volume in August 2011, according to Wedbush. As one industry leader said to us so succinctly this weekend, the ability to "instantly switch from risk on to risk off and vice versa today is unprecedented." Perhaps highly volatile public markets are the new normal.

Illiquidity. Since September 16, 2008 when the Reserve Primary Fund broke the buck due to write downs of Lehman Brothers debt, institutional investors have had a heightened anxiety about liquidity across all assets classes. That September there was a brief run on money funds as mass redemption requests forced money funds to liquidate

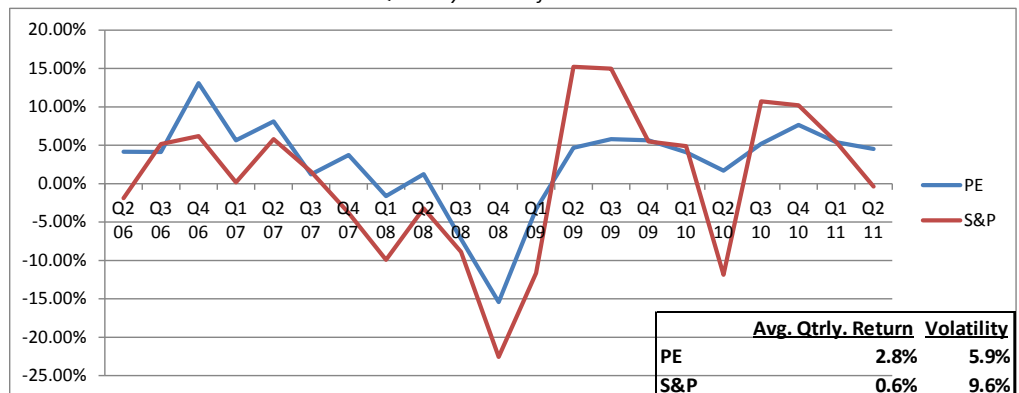
assets or limit redemptions until the Treasury stepped in to insure participating money funds (much like the FDIC does with bank deposits). The acute anxiety—the panic—that so many investors in those money funds felt when their most liquid asset froze up still lingers today. In fact, the aftermath is directly affecting private equity funds today.

Private equity managers require investors to make long-term commitments to their funds—typically 10 years, although the actual contributed capital scales up over several years and then down over the next several years. Combine the above described market volatility with a little general anxiety about liquidity and investors become reluctant to make new commitments to private equity funds because they get fixated on the multi-year aspect of it. What if I need that money next year? What if the stock market crashes again and I become over-allocated to private equity (the so-called denominator effect)? Valid questions, perhaps. But shouldn't investors be allocating only that portion of their total assets to private equity that they know they won't need in the short-term? Similarly, if investors don't invest in private equity and other alternatives, where are they going to get enough investment return to pay the bills? Three-month Treasuries yield 0.01%, the 10-year yields 2.04% and the S&P 500 has been exactly flat for 2011 (1258 opening on Jan. 3, 2011 vs. 1258 closing on Dec. 6, 2011). While the emotional side of the brain is steering many down too conservative a path, the logical side should be counter-balancing it with a longer term, practical view.

Consider the following quarterly returns data from Cambridge Associates during the last five years (as high frequency trading and ETFs became common). Note private equity returns were higher and volatility was lower than corresponding data for the S&P 500.

Cambridge U.S. Private Equity Index vs. S&P 500

Quarterly Returns for Last Five Years



The Cambridge Associates U.S. Private Equity Index is derived from performance data compiled for funds raised from 1986-2010. The index represents up to two-thirds of the total dollars raised by U.S. buyout, mezzanine and restructuring firms during that time. Follow this [link](#) for entire data set since inception in 1990.

Conclusion

Private equity is an important tool in your investment portfolio. It can enhance return and reduce volatility. Liquidity comes from other parts of your portfolio. As you make new allocations to private equity, you should also review your short-term / liquid investments to verify they will continue to perform as advertised. Finally, it is worth pointing out that although the typical legal term of a private equity fund is 10 years, we checked to see how long we typically held onto the first capital called in our past funds. On average, it was just over three years.

We Want Your Feedback

We relentlessly strive to create smart, forward-thinking funds that meet or exceed clients' investment needs in today's global economy. Past innovations include (1) menu options for venture, buyouts, cleantech and direct investments; (2) North America's first cleantech private equity fund of funds and (3) most recently what we believe is the

world's first 2/20 fund of funds (where net fees to the LPs are expected to be the same for a well-diversified FFs as the fees would be for a typical less-diversified investment in a single private equity fund).

We are asking for your direct input for 2012-13. Please take 90 seconds to complete a short seven question survey by following this link. For each completed submission we will donate \$10 to the Salvation Army.¹ It takes about 90 seconds and benefits a worthy charitable organization.

[Begin Survey Now](#)

Upcoming Events

We are regular speakers and attendees at key industry conferences. We hope to see you at these upcoming events.

January 22-24 **Made in America 2012**, 9th Annual Taft-Hartley Benefit Summit
Las Vegas, NV www.frallc.com/events/mia

March 26-28 **CleanTech Forum 2012**, San Francisco
<http://events.cleantech.com/sanfrancisco>

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¹We will make one donation per each investor or consulting firm, so multiple submissions from the same investor or firm will count as one joint submission.

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