

DIVERSIFICATION NATION

Private equity helps you get more out of Canada.

BY PIERRE LUC GARIÉPY

The financials, energy and materials sectors dominate the S&P/TSX Composite Index, representing almost 75% of its value. So how can investors effectively gain greater exposure to the remaining sectors and build a more balanced equities portfolio?

The answer may lie in the Canadian private equity market. Institutional investors can view Canadian equities as a single asset class and consider the additional sector diversification benefits of private equity when determining their future allocations to Canadian equities.

There are significant benefits to adding private equity to an investment portfolio: superior long-term returns relative to public equity indexes; increased equity investment opportunities versus those available in the public markets; and reduced overall portfolio risk through low correlations to more traditional asset classes. In addition to these benefits, investing in private equity can provide added diversification through broader exposure to all sectors of the economy.

Private Versus Public

Over the long term, private equity has consistently outperformed public market benchmarks, providing a performance premium beyond what is typically expected for committing capital for 10 years or more. If we look at long-term performance data comparing private and public equities in Canada, the U.S. and Europe, private equity clearly outperforms public markets. Furthermore, Canada has historically generated the greatest relative outperformance, since our private equity market is still in the early stages of development and is therefore less efficient.

There are other factors driving the ability of private equity to outperform. For example, better alignment of interest between investors and the firm provides a strong incentive for everyone involved to work together to select and extract the most value from the best opportunities. At the same time, having full access to company information prior to completing an investment allows private equity managers to develop more robust business plans and reduce risk by structuring and negotiating appropriate terms. A longer-term perspective and active management on the part of private equity managers also ensures planning for long-term value rather

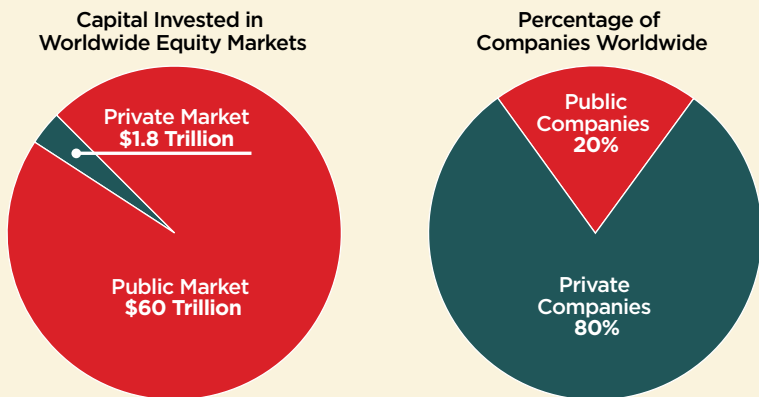


than just positive quarterly results in the short term. Finally, direct strategic and operational control on the part of investors ensures rapid resolution of issues and can drive the most appropriate and timely exit strategy.

Opportunities Abound

There are significantly more opportunities to invest in private companies than in public companies, both in Canada and around the world. Based on our analysis, it is estimated that approximately 80% of companies around the world are private. The amount of capital invested in private companies globally is only roughly \$1.8 trillion compared to the value of the public markets of about \$60 trillion (Figure 1). In the very fertile Canadian private equity market, opportunities far exceed the capital that is currently

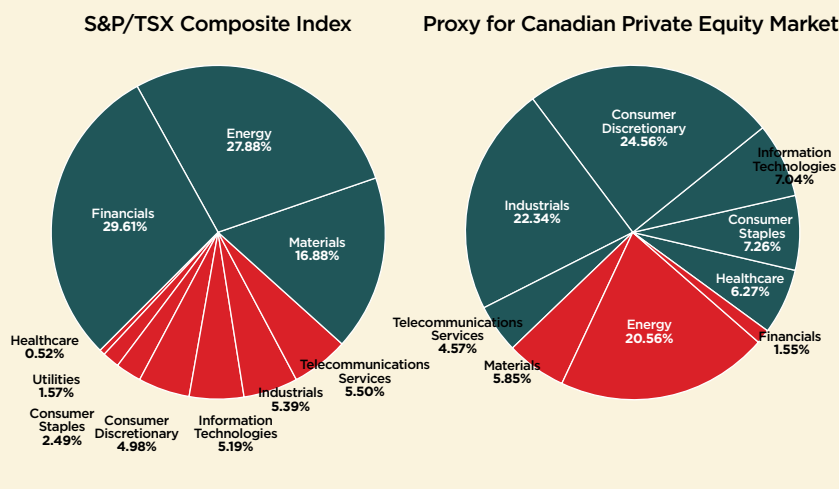
Figure 1: Public Versus Private Equity Markets



Source: Prequin, World Federation of Exchanges

ADDING ALTERNATIVES TO A PORTFOLIO OF PUBLIC STOCKS AND BONDS CAN INCREASE THE OVERALL RISK-ADJUSTED RETURN.

Figure 2: Canada Sector Breakdowns (as of Dec. 31, 2007)



Source: Kensington Investment Management and S&P/TSX

available. Approximately \$75 to \$100 billion in private equity capital is currently allocated in Canada for investment in private equity opportunities, with an estimated value of \$1.5 to \$2 trillion. We believe that this imbalance will continue for the foreseeable future and that investment opportunities will continue to be readily available to Canadian private equity managers. For those who think too much money is chasing too few deals in the private equity market, Figure 1 shows that this is clearly not the case.

Private equity and other alternative investments have historically exhibited low or negative correlation with more traditional asset classes. Adding alternative investments such as private equity to a portfolio of public stocks and bonds can increase the overall risk-adjusted return of the portfolio (i.e., reduce overall risk for the same level of performance and/or increase performance for the same level of overall risk).

Diversification Benefits

Figure 2 shows the sector breakdown of the S&P/TSX Composite Index as of Dec. 31, 2007. It highlights the concentration limitations inherent in investing only in Canadian public equities. As mentioned earlier, the index is dominated by just three sectors: financials, energy and materials. This level of concentration could certainly be considered beyond the prudent limits of many institutional portfolios.

Comparable data is not readily available for Canadian private equity. However, for the purposes of comparison, we have used Kensington Investment Management’s broadly

diversified Canadian private equity fund of funds (as of Dec. 31, 2007) to show the sector exposure that Canadian private equity can provide.

The Kensington portfolio contains investments in more than 90 private Canadian companies. Canadian private equity provides access to very different sectors of the Canadian economy compared to the S&P/TSX Composite Index. The financials, energy and materials sectors represent a little less than 28% of our private equity proxy, meaning that an allocation to Canadian private equity would clearly help broaden exposure to different areas of the Canadian economy.

Any allocation made to public Canadian equities implies that institutional investors are making a significant bet on three sectors of the Canadian economy. Though this strategy has paid off in recent years, the future is uncertain.

If the performance of these dominant sectors turns flat or negative for an extended period, it would have a significant negative impact on the total long-term returns of pension plans and their ability to meet their pension commitments. Investing in Canadian private equity could mitigate some of this risk by further diversifying allocations to Canadian equities. While investing in private equity provides the benefits of long-term outperformance, increased access to investment opportunities and reduced portfolio risk, adding Canadian private equity creates exposure to sectors of the economy that are poorly represented in the overall index. ■

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