

## Avalos, Elizabeth

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**From:** Pena, Roberto  
**Sent:** Thursday, January 08, 2009 3:35 PM  
**To:** Skowronski, Robert  
**Cc:** Avalos, Elizabeth  
**Subject:** RE: Emailing: 10456445 Article on private equity that warns about due diligence.

Thanks Robert, we will make sure to share it with the Board.

Roberto L. Peña  
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Fresno County Employees' Retirement Association  
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**From:** Skowronski, Robert  
**Sent:** Thursday, January 08, 2009 3:32 PM  
**To:** Pena, Roberto  
**Subject:** FW: Emailing: 10456445 Article on private equity that warns about due diligence.

Dear Mr. Pena perhaps this is another point of view the Board of Retirement needs to consider. The Board of Retirement should be given both side of the issue in an unbiased manner not just the sales pitch. A more conservative investing approach (less risk with real assets) may be a wiser investment strategy. Sincerely Robert Skowronski Fresno County Retiree

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**From:** Skowronski, Robert  
**Sent:** Thursday, January 08, 2009 3:10 PM  
**To:** Skowronski, Robert  
**Subject:** Emailing: 10456445

<< File: 10456445.htm >>

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## The End of the Private Equity Party

**David MacDougall**

01/07/09 - 10:34 AM EST

Investing in a publicly traded private equity firm such as **The Blackstone Group** (BX Quote - Cramer on BX - Stock Picks), **KKR** (KFN Quote - Cramer on KFN - Stock Picks) and **Fortress Investment Group** (FIG Quote - Cramer on FIG - Stock Picks) during a credit crunch requires a bold dismissal of due diligence.

Unlike most investment companies, large private equity firms' portfolio construction and performance are impossible to know because of a lag in reporting and a secrecy of holdings. In addition, exorbitant fees and new accounting rules may make private-equity firms crumble in the new world of tight credit and renewed conservatism.

Blackstone, KKR and Fortress are all rated "sell" by TheStreet.com Ratings. Blackstone's shares have fallen 54% in the past year, and KKR's have tumbled 84% and Fortress' 85%.

Private equity firms tend to produce quarterly performance reports as many as five months after the close of a quarter. This means investors act on information that is usually irrelevant, particularly in current market conditions, where benchmark indices have posted the biggest declines in decades.

For example, if a private equity fund was carrying an investment in a financial institution that melted down in the second half of last year, the losses may not turn up in financial statements until the numbers are calculated for the fourth quarter, which might not be until May, making the loss finally visible in second-quarter 2009 filings. What comes to mind is TPG's ill-fated investment in **Washington Mutual** (WM Quote - Cramer on WM - Stock Picks), which was seized by the FDIC six months after TPG led a \$7 billion investment. Or JC Flowers' disastrous \$1.2 billion investment in **Hypo Real Estate** just three months before the German government and a consortium of banks bailed out the firm.

Under those circumstances the loss is, in effect, masked for nine months, keeping crucial information from investors about the true state of the firm.

Even with this potential landmine, hot money has poured into private equity funds for years as investors confused easy investment exits into overheated markets at amazing returns for actual alpha created by management. Current market conditions, however, have exposed this supposed magic as little more than smoke and mirrors.

Future fund raising even by the most respected private equity firms could be seriously altered. Major institutional investors may become wary of the long lock-ups (usually 10 years) and big price tags for funds that may no longer offer such exceptional returns.

Big-name firms such as Blackstone, KKR and Fortress could become far less profitable as fund sizes fall and returns fizzle due to falling share prices. Profitability is already in question, as Blackstone and Fortress posted operating margins of -631.84% and -81.53%, respectively, in the third quarter.

Eager investors have long been lining up at top private equity firms to get a slice of new funds. The best firms have been able to handpick their investors -- who in turn are more than willing to pay 2% management fees along with 20% performance fees -- similar to those on hedge funds. Such fees weren't considered unreasonable during the bull market. Private equity funds could generate returns that exceeded those of the

**S&P 500**, even with gigantic fees.

Commitments to major funds skyrocketed in the past few years. Several funds raised more than \$10 billion, based only on past performance, with single institutions making investments of more than \$1 billion. The California State Teachers' Retirement System put \$1.74 billion into Blackstone V.

Now, investors are desperately trying to dump private equity commitments on the illiquid secondary market at huge discounts from the fair market value stated by the fund in the hopes of avoiding further so-called capital calls from the fund. Private equity commitments can be drawn down through capital calls whenever the fund decides that it can use the money. Capital calls can easily total millions of dollars, forcing investors to liquidate other investments that have sustained serious losses to cover the commitment.

Investors buying secondary commitments face a fair amount of risk in purchasing the commitments due to the questionable manner in which the valuations are calculated.

Recently, a new accounting rule, FASB 157, has changed the way private equity funds value investments. While adherence to the rule is optional for closely held companies, publicly traded firms such as Blackstone, KKR and Fortress are required to follow the new guidelines.

Before the new rules, a private equity firm could value investments at any amount that the managers determined to be fair. The valuation was usually held at the price the fund paid for the investment until it would be realized, at which point the gain or loss could finally be seen by investors.

This enabled the managers to keep their worst-performing investments at cost to avoid hurting returns while at the same time raising another fund. By the time the poor investments were finally realized, the fund would have had a much longer time period to spread out the loss, improving the annualized return, and the firm would most likely be well into the subsequent fund's life cycle, shining a light on its performance rather than the previous fund's.

FASB 157 will force publicly traded firms to mark their investments to market, meaning they will need to find comparable publicly listed investments on which to base valuations. This will force firms to identify poorly performing investments before they are realized. Without the ability to hide bad calls on the schedule of investments, performance could suffer, hobbling fund raising.

The full impact of private equity commitments' performance this year has yet to be felt by investors, and the real story may not be known until the summer as private equity funds, notoriously slow in reporting results, reveal how they fared in the crash.

With the new accounting rules now in effect, it is difficult to argue that private equity funds' performance would be any different from the market as a whole. One of the most enticing aspects of alternative assets is diversification from the general market. With that benefit having evaporated and illiquidity ever present, it is hard to imagine a reason to commit any capital to private equity at all.

To top it off, funds will now have a much harder time obtaining the leverage that can supercharge returns. Lending, even for the safest borrowers, has ground to a halt. As such, Blackstone, KKR, Fortress and any other private equity firms that come to market are unsustainable, spelling what is probably the beginning of the end of private equity firms' foray into public financing .

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