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FOCUS ON PRIVATE EQUITY

HOW TO POTENTIALLY ENHANCE EQUITY PERFORMANCE IN A CLIMATE OF UNCERTAINTY

February 2017

As challenging as the investment landscape has been, we expect it to be even more so going forward. Global growth is slow, and the returns we have seen in recent years have been pulled forward by quantitative easing and the low interest-rate environment. Over the next ten years, returns are likely to be lower across all asset classes than they were during the past ten years.

In that context, we offer three themes investors can potentially utilize to enhance the returns of their equity portfolios. These themes underscore the reasons we believe private equity can be a useful component of investor portfolios in this kind of climate.

1. **A long-term approach.** While many investors focus on actively trading their equity investments, we believe it takes years to create genuine value. That's why we emphasize the importance of making long-term commitments to provide a framework for enduring value creation.

2. **Less efficient markets.** The US market happens to be a great example. There are about 20,000 US companies with 500 or more employees, and approximately 80% of them are private companies. Many are family-owned. That provides a terrific universe to find situations where a knowledgeable investor like Kohlberg Kravis Roberts & Co. L.P. (collectively, "KKR") can add value.

3. **Control.** The importance of this factor can't be overstated. As a passive or index-style investor, you hope for strong returns. As an active private equity investor with control, you can fix problems, improve the underlying assets, and create enduring value. KKR Capstone—an operational team of highly experienced industry executives and functional specialists—focuses on improving companies from an operational perspective, starting in the first hundred days of an investment. The team works exclusively for KKR and its portfolio companies on the ground in partnership with management teams to create sustainable improvements.

KKR Capstone is not a subsidiary or affiliate of KKR.

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Portfolio Manager,
Director of Research and Sourcing

This article is excerpted from a recent Altegris-KKR webinar, *Politics & Your Portfolio*. You may be interested in two other excerpts, *The Political Bull Market and Your Portfolio* and *Can ESG Investors Do Well While Doing Good?*

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CAUTION FLAGS

In our view, financial markets currently are somewhere on the continuum between fairly valued and richly valued. If you believe interest rates will remain low for a long period of time, then you might see today's markets as fairly valued. If, on the other hand, you think rates could rise sharply and quickly, equity markets are overvalued in a historical context.

In this environment, investors must be careful to have a very granular understanding of assets *before* they invest. We currently see no pockets of significantly cheap assets and no major themes from a buying perspective. Rather, the path to success is avoiding assets that are substantially overvalued from a fundamental perspective and likely to underperform in the years ahead.

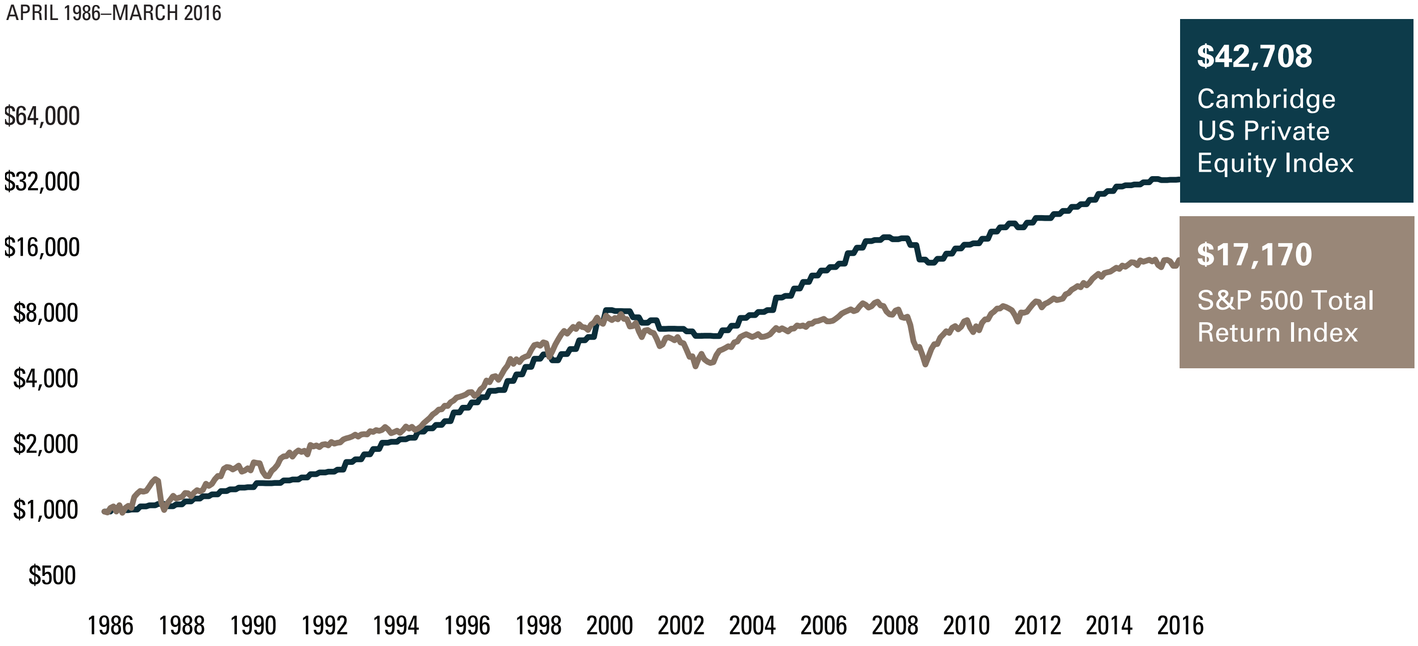
That translates into staying away from more cyclical areas of the economy, including energy, industrials, and materials. They currently represent approximately 20% of the S&P. Areas where we see more opportunity include companies that focus on the value-based consumer, in addition to pockets of the healthcare, IT and financials sectors. Even if the economy goes into a mild recession, a 1% or 2% contraction in GDP won't prevent consumers from buying their heart medication or replacing a pair of eyeglasses when they break. We also believe that projects aiming to achieve environmental improvements or positive social impacts will have staying power, even in a slow-growth economy. In our view, businesses where the underlying customer is resilient and there's a strong positive theme of societal benefit will be able to preserve or grow cash flows, even if there is a very-low-growth environment ahead.

A PROBLEM-SOLVING APPROACH

Whenever we discuss private equity, two questions come up most frequently—specifically, how to think about allocations to private equity, and what role those allocations play in investor portfolios.

PRIVATE EQUITY HAS HISTORICALLY OUTPERFORMED PUBLIC EQUITY

VALUE of an INITIAL $1,000 INVESTMENT (Logarithmic Scale)
APRIL 1986–MARCH 2016



Source: Cambridge Associates, Bloomberg based on data from S&P

Past performance is not indicative of future results. There is no guarantee that any investment will achieve its objectives, generate profits or avoid losses. There are significant differences between public and private equities, which include but are not limited to, the fact that public equities have a lower barrier to entry than private equities. There is also greater access to information about public companies. Private equities typically have a longer time horizon than public equities before profits, if any, are realized. Additionally, public equities provide greater liquidity whereas private equities are considered highly illiquid.

Cambridge US Private Equity (PE) Index data based on quarterly returns. S&P 500 Total Return Index data based on monthly returns. Date range based on common period of data availability. The referenced indices are shown for general market comparisons and are not meant to represent any particular investment. There are significant differences in the risks and potential for volatility of the Fund relative to an index. An investor cannot invest directly in an index. Moreover, indices do not reflect commissions or fees that may be charged to an investment product based on the index, which may materially affect the performance data presented.

A logarithmic scale plots prices as an equal percent change between two price points, whereas a linear scale plots prices as an absolute change in price.

Investors are often surprised that we don't think of private equity primarily as a diversifier to public equity investments. While it may certainly aid in diversification, the underlying risks and growth drivers of this strategy are comparable to those in public equity markets. We therefore view private equity primarily as a potential return enhancer for investors' overall equity portfolios, and believe the strategy's long-term benefits will derive from enhancing portfolio returns in a low-return world.

Depending on an investor's time frame, liquidity needs, and risk tolerance, our suggested allocation to private equity ranges anywhere from 5% to 30% of an investor's total equity allocation. If you assume that equities represent between 50% and 70% of equity portfolios, that suggested recommendation translates to between 2.5% and about 20% of an investor's portfolio.

These days we see many astute clients thinking more deeply about private equity investments. We're living longer, we're healthier, and we have very long time horizons to retirement and post-retirement. In this context, one can see why short-term thinking may be detrimental to investors' long-term goals. Conversely, for many investors, a greater buy-in, in terms of duration of their assets, makes intuitive sense.

Investors with that long-term perspective may consider taking advantage of the illiquidity premium.[1] One specific problem investors encounter when allocating to private equity is diversification within the private equity space. Investments in a primary private equity fund are often concentrated in 20 to 30 investments that the fund will make over a three- to five-year period, typically in one geographic region. We believe that is insufficient diversification. One way to mitigate this is to invest across multiple geographic regions, or look at multiple vintages (year an investment is made) and strategies.

VOLATILE TIMES

Earlier we discussed the rising politicization of business, a factor that cannot be ignored when considering how to invest in this climate. In our view, attention to issues revolving around trade, immigration, and globalization can only increase. Populism always rises in periods when people are less certain of their place in the economic order. The radical transparency created by the Internet is another force not to be underestimated. Today anyone with a smartphone can broadcast to the world, if the message is thoughtful and creative enough. No longer must company critics have a big name or a PR firm to have a major impact.

What makes private equity investing a good fit with this environment? It's because it takes a longer-term view and involves playing an active role in governing companies. It also offers the potential to outperform the equity market, which is an important consideration if we are in a lower-return environment for the foreseeable future. While the historical performance of private equity relative to public equity has varied through the years, over the last 30 years the Cambridge US Private Equity Index has outperformed by an average of about 4% a year. For all these reasons, we believe private equity is more relevant than ever in today's investment landscape.

Past performance is not indicative of future results. Diversification does not ensure profit or protect against loss in a positive or declining market. There is no guarantee any investment will achieve its objectives, generate profits, or avoid losses.

[1] The illiquidity premium: Forgoing frequent liquidity can be rewarded with enhanced returns. This is a primary reason why investors should consider private equity.

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RISKS AND IMPORTANT CONSIDERATIONS

It is important to note that all investments are subject to risks that affect their performance in different market cycles. There are significant differences between public and private equities, which include but are not limited to, the fact that public equities have a lower barrier to entry than private equities. There is also greater access to information about public companies. Private equities typically have a longer time horizon than public equities before profits, if any, are realized. Public equities provide greater liquidity whereas private equities are considered highly illiquid.

It should be noted that private equity may not be suitable for everyone. As with any investment, there are numerous risks to investing in private equity including the possible loss of principal. Private equities generally are more expensive to purchase and own than public equities, which if taken into account would decrease private equity performance shown.

Nevertheless, for those investors who understand the risks, and have available risk capital, private equity can provide an opportunity to enhance their portfolio returns.

An important part of understanding and implementing private equity today is assessing the potential benefits as well as the risks. Equity securities are subject to market risk, or risk of loss due to adverse company news, industry developments, and general economic decline.

In addition, private equity is considered speculative therefore subject to a unique set of risks. These risks include, but are not limited to, liquidity risk and lack of a secondary market to trade securities, management risk, concentration and non-diversification risk, foreign investment risk, lack of transparency, leverage risk, and volatility.

ABOUT ALTEGRIS

Altegris is an investment research firm, with deep expertise in alternative manager selection, structuring unique solutions, and providing portfolio management and oversight. Beginning with an analysis of the current and anticipated investment environment, our solutions are based on themes that we believe solve the most important client needs. For more information about the Altegris family of alternative solutions, visit www.altegris.com.

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