

# WEALTH MATTERS

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Volume 21 Number 4

Fourth Quarter 2007

## Private Equity

An expensive and riskier way to own value companies.

(1) "The Business of Making Money", *The Economist*, 7 July 2007, p 68)

(2) "Going Private", *Business Week*, 27 Feb. 2006, p56.

(3) As the normal size of leveraged buyout deals has increased, more private equity firms are pooling their capital and bidding as groups. Although these firms may attempt to diversify across multiple acquisitions, investors who hold a stake in multiple private equity deals face the rising chance that they may magnify their exposure if the funds participate in the same buyout. ("Riding the Rise in Private Equity", *Worth*, p54.)

(4) A recent example of rising market resistance may be the Blackstone IPO. Since market trading began on Blackstone last month, shares in this large private equity firm have fallen below their offering price. ("The Trouble with Private Equity", *The Economist*, 7 July 2007, p11.)

(5) "Riding the Rise in Private Equity", *Worth*, p52.

(6) "Not Just for the Big Guys", *Business Week*, 12 Feb. 2007, p92.

(7) "Private Equity Performance: Returns, Persistence and Capital Flows," by Steven Kaplan and Antoinette Schoar, *Journal of Finance*, Aug. 2005.

(8) "The Performance of Private Equity Funds", by Ludovic Phalippou and Oliver Gottschalg, <http://ssrn.com/abstract=686782> April 2007.

(9) "Smart Institutions, Foolish Choices?", by Josh Lerner, Antoinette Schoar and Wan Wong, *MIT Sloan Research Paper* 4523-05, Jan. 2005.

The common private equity model seems compelling: A buyout firm pools capital from wealthy investors to purchase undervalued companies. The manager

highly leverages the firm and hires top managers who refine strategy, streamline operations, develop new markets and create a well-oiled profit machine. After a few years, the management team converts this value to cash by taking the company public or negotiating a sale or merger.

That's how it works on paper, anyway.

The industry's high-profile success stories have attracted billions of capital from institutions and wealthy individuals. In recent years, even smaller investors have found ways to own private equity funds that offer the promise of getting rich on value companies the market has passed up.

According to Private Equity Intelligence, the industry has raised \$240 billion in the first half of 2007, well on the way to surpassing last year's record \$459 billion. That far exceeds the \$10 billion raised in 1991.<sup>(1)</sup> By one estimate, private equity firms control about \$800 billion in capital, compared to about \$1 billion 15 years ago.<sup>(2)</sup>

Private equity now appears to be moving through the boom phase of the investment product life cycle. From a macro economic standpoint, the private buyout model may benefit the economy by squeezing out corporate inefficiencies, providing a market for more sophisticated debt instruments, and fueling innovation across industries. But the benefits traditionally offered to individual and institutional investors are suspect.

While the private equity model may suit some affluent investors, the basic strategy and common practices may run contrary to sensible investing. Consider these problems:



- **Risky strategies and shaky fundamentals.** Private equity managers make concentrated bets in a handful of companies they consider to be undervalued.<sup>(3)</sup> They typically load up these companies with massive levels of debt to recoup their investment. Since most managers' sale window is five to eight years, they are not thinking about the long term.

- **Lack of transparency.** Public companies are accountable to investors and regulators, while private equity managers keep much of what they do a secret. This includes their compensation and perks. Moreover, their strategies and plans may not be submitted for scrutiny to investors.

- **High acquisition and management costs.** Private equity firms typically receive compensation similar to hedge fund managers, with a 2% annual management fee and 20% of future profits (known as "two and twenty"). These high costs place a heavy burden on investment economics. Equally troubling, the private equity boom has intensified competition for acquisition targets, which has driven up company valuations and sales prices. High fees and inflated prices drive down returns and require ambitious assumptions about future growth, profits and cashout.

- **Uncertain exit strategy.** Private equity firms need an exit route to convert their holdings to cash

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# Fighting Inflation

## Is Federal Reserve policy losing its punch?

When the Federal Reserve talks, people listen. Companies, economists, Wall Street, government and economy watchers all scrutinize messages offered by Fed officials and their leader, Chairman Bernanke. Their interpretations usually concentrate on the central bank's view of the inflation trend and the implications for interest rate policy.

The Fed tries to manage inflation and direct the economy by adjusting interest rates and the money supply. Some experts believe that these policy tools have lost potency and that many forces beyond the Fed's control now wield growing influence over inflation.

The evidence is found in the Fed's current challenge to contain inflation. Despite 17 quarter-point rate increases since June 2004, the economy has remained stubbornly vibrant<sup>(1)</sup> and core inflation has moved beyond the Fed's 1-2% comfort zone, although it has fallen gradually during 2007.<sup>(2)</sup>

Let's consider some of the inflation determinants that are considered beyond the Fed's direct control:

- **Energy prices.** The Fed's policies have only distant leverage on global energy prices. Other factors, such as geopolitical tensions, worldwide supply and demand, OPEC policy, U.S. refining capacity, speculative trading and weather patterns all play a more vital role. This may be why the Fed tracks core inflation, which excludes food and energy from index calculation.

In 2006, energy usage remained strong even as oil prices pushed to record highs. Oil at \$70 per barrel may have modestly boosted core inflation—but also assisted the Fed by dampening economic growth as companies began to pass along higher fuel costs to consumers. But the dampening effect was short lived, as retreating oil prices are now easing inflation and may revitalize GDP growth.

- **Housing prices.** The Consumer Price Index (CPI) uses owner equivalent rent (OER) to measure home price inflation. But the metric can produce misleading data for the CPI when home prices and residential rents diverge. This occurs when rising

interest rates put downward pressure on home prices while pushing rents upward. Conversely, housing prices were climbing rapidly from 2003 to 2005—but rents stagnated. In 2006, rents began to catch up just as home prices began to fall.

- **Exchange rates.** Changes in the dollar's value relative to other major currencies can affect inflation. A declining dollar raises the cost of imported goods while also lowering the returns of foreign investment in the U.S. These changes ultimately impact future capital flows, the trade deficit and economic growth. In 2006, the dollar declined drastically against major currencies. Prices have not climbed considerably

because some Asian economies peg their currencies to the dollar and other foreign exporters have been forced to cut prices to compete in the world market.

- **Labor costs.** In recent months, the unemployment rate has stayed in the 4.5% range, which is below what the Fed considers to be the "natural rate".<sup>(3)</sup> Strong employment drives up wages, which raises business costs and squeezes profit margins. But in the current expansion, wage growth

has been weak, as rising productivity has restrained unit labor costs.<sup>(4)</sup>

- **Global economic forces.** Today, the U.S. economy is more closely linked to global forces. Imports and foreign investment are two major inputs. The Fed must implement policy amidst an overwhelming flow of goods and money across national borders. This may be one reason why the Fed's rate hike campaign that began in 2004 has yet to produce a convincing economic slowdown. Cheap imported goods have kept prices contained while foreign capital flowing into the U.S. markets has offset the Fed's attempt to reduce the supply of money and credit.<sup>(5)</sup>

This weakened policy clout may reduce the chances that the Fed will navigate a soft landing. The CPI and other key indicators are delivering mixed signals on real inflation and economic strength—and this lack of clarity may keep the markets guessing. Fed Chairman Bernanke has observed on several occasions that the economy remains strong, inflation is still above the Fed's comfort zone, and future rate hikes may be necessary.

This hawkish inflation message runs contrary to a growing sentiment among economists that GDP is slowing, inflation risks are fading, and the Fed should prepare to strike an accommodative monetary policy later this year or in 2008. ■

(1) Unemployment remains low, corporate profits strong; industrial output utilization above the long-term average, and consumer spending robust. GDP during the second half of 2007 is expected to rebound from the first quarter low.

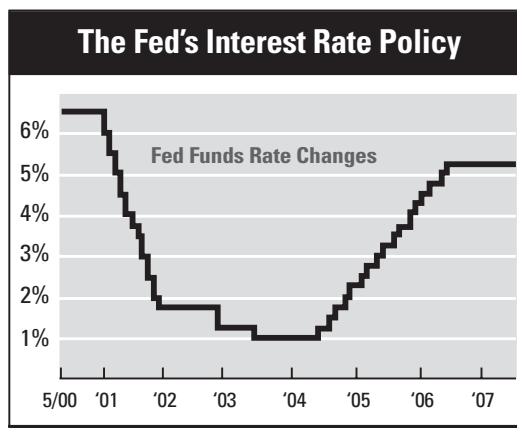
(2) In June, core inflation (excluding food and energy) was 2.2% year-over-year. Headline (overall) inflation was 2.7% for the last 12 months. In 2006 (as measured year-over-year in Dec.) core inflation rose 2.6% and headline inflation 2.5%. (Source: Bureau of Labor Statistics)

(3) The Fed believes that, compared to 20 years ago, the new economy requires up to twice as much unemployment to bring down inflation by the same amount. This is one reason why the Fed has so far delayed switching to an accommodative monetary policy and has avoided any talk of doing so. ("Policy Makers at the Fed Rethink Inflation's Roots", *The Wall Street Journal*, 26 Feb. 2007, A1)

(4) Ironically, in the foreign labor markets, U.S. businesses suffered rapid wage growth in 2006. American companies went overseas to get cheap labor, but now are finding skilled labor in short supply and costly to hire.

(5) Since 1995, imports have risen from 12% to 17% of GDP, and foreign sources supply about 32% of U.S. domestic investment. Despite over a four percentage point increase in the Fed funds rate since 2004, the 10-year government bond was yielding 4.6% in late November—the same level as when the rate hikes began.

("Can Anyone Steer This Economy?", *BusinessWeek*, 20 Nov. 2006, pp 57-62.)



Source: Federal Reserve Board

# Global Real Estate

Investors look overseas for broader diversification.



(1) Foreign investments involve special risks, including greater economic, political and currency fluctuation, which may be even greater in emerging markets.

(2) A Real Estate Investment Trust (REIT) is a corporation that invests in real estate and passes through income to investors. Like other corporations, REITs can be publicly or privately held—and public REITs may be listed on various stock exchanges. In the U.S., a REIT must distribute at least 90% of annual income to investors. Foreign countries have their own laws specifying required distributions and other issues. A REIT's two return components are income distributions from rents and price appreciation.

(3) "Spanning the Globe", Real Estate Portfolio, National Association of Real Estate Investment Trusts (NAREIT), Nov. 2004, <http://www.nareit.com/portfoliomag/04special/p60.shtml>

(4) Total returns for the FTSE EPRA/NAREIT Global Index through 4/27/07. Source: National Association of Real Estate Investment Trusts (NAREIT). Past performance is no guarantee of future returns. You cannot invest directly in an index.

(5) For instance, REITs or REIT-like structures have been created since 2001 in Japan, France, Singapore, Hong Kong, South Korea, U.K., and Germany. Australia and the Netherlands have allowed real estate securities since the early 1970s, and Belgium and Canada since the early 1990s.

**F**oreign property ownership has a long and distinguished history as an effective hedge against economic and political uncertainty. For centuries, wealthy families have acquired foreign residences and held stakes in business ventures that often involved land. In more recent times, institutional investors have acquired foreign operating properties to achieve broader diversification. Now more individual investors are including global real estate in their portfolios.

International real estate should grow even more appealing in the future. The globalization of business and trade is spurring economic growth and raising living standards in both developed and emerging economies. This prosperity also fuels commercial and residential real estate development.

The correlations among international real estate securities have been found to be low across countries and regions—and within each country's equity markets. This builds a compelling case for holding international real estate in a globally diversified portfolio. Today, individuals have a ready means to own foreign property through real estate investment trusts (REITs) and REIT-like securities.<sup>(1)</sup>

## The REIT structure

Real estate is a local business. Anyone who has purchased a foreign residence knows that differences in language, culture, business practices, laws and local markets all complicate ownership and present risks that are not readily quantified or managed from a distance. This is also true when venturing into foreign markets to buy office buildings, retail stores, hotels, industrial properties and other real estate.

The REIT is structured for market liquidity, passive ownership, management transparency, lower cost and favorable tax treatment.<sup>(2)</sup> The same features that have made U.S. REITs useful for small investors now are providing an avenue for individuals to hold a foreign real estate component in their portfolio. The last few years have seen creation and rapid advancement of REITs or REIT-like structures in foreign countries as more real estate has moved into the public securities markets and global capital flows have increased. As a result, some foreign REIT investment sectors are demonstrating growth trends similar to the U.S. REIT market in the early 1990s.<sup>(3)</sup>

Returns among international real estate securities offer evidence of this growth. Over one, three and five-year periods, Asian REITs have delivered total returns of 37.6%, 28.7% and 28.5%, respectively. European REITs have earned 40.9%, 37.0% and 35.4% for the same periods.<sup>(4)</sup>

## A case for indexing

While international REITs open the door for broader diversification, an active management approach carries significant risks, including:

- **Insufficient diversification.** A REIT manager may over concentrate in a single property type or local market. Even a more diverse portfolio of properties may not offer a complete proxy of the real estate market in a country or region.

- **Lack of standardization.** Legal structure, ownership rules, investment restrictions, dividend requirements, tax treatment and other issues are specific to each country. Although the global REIT market is moving toward standardization, there are still many differences to navigate.

- **Unreliable asset class exposure.** A manager may change strategy regarding property mix and country exposure—or make other decisions that impact risk and diversification in the REIT. These policy changes also may affect characteristics of the real estate component in an investor's portfolio.

- **Market risk.** REITs are subject to global market forces, as well as to factors affecting specific-country stock markets or equity asset classes, such as small company stocks. The investment's market value may be higher or lower than the real estate assets held in the portfolio.

- **Manager experience.** REITs are a new investment sector in some countries.<sup>(5)</sup> Foreign managers involved in these markets may have a limited track record and may operate in an environment that lacks legal and business precedent. Moreover, U.S. REIT managers who want to hold overseas properties could face a steep learning curve as they build portfolios in less familiar economies and sectors.

These and other risks underscore the importance of diversifying extensively in foreign real estate.\* This may be best achieved through a global indexing strategy that attempts to hold a thoroughly diversified portfolio of REITs, REIT-like securities and real estate company stocks.

By spreading risk across many countries and real estate portfolios, an investor may reduce exposure to risks affecting individual companies and local real estate markets. A structured indexing approach also may help an investor diversify further as the universe of real estate securities expands. ■

\*More conventional investment risks include those experienced in the stock market, real estate industry, foreign securities, currency markets, emerging markets, small companies and in the use of derivatives for hedging and non-hedging purposes.

## Private Equity

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and pay off investors. The most common avenues are initial public offerings (IPOs) and sales to other companies or private equity groups. But more expensive debt, dwindling returns and eroding economics could make future buyers and investors reluctant to band together to make the next record-breaking deal.<sup>(4)</sup>

• **Questionable performance.** According to figures available in the venture capital industry, from 1986 through 2006, private equity funds averaged about 14.2% annually. For the year ending June 30, 2006, private equity funds returned an average 22.5%.<sup>(5)</sup> Another industry source reports an 18% annualized return between 1980 and 2005.<sup>(6)</sup>

But academic research casts doubt on these numbers. One study found that average returns, net of fees, were roughly equal to the S&P 500's annual return between 1980 and 2001.<sup>(7)</sup> A recent study suggests that firms values held in private equity portfolios are overstated—and that after adjusting these values downward, private equity has failed to match S&P 500 performance.<sup>(8)</sup> Moreover, another well-known study found a significant performance gap among private equity ventures held by pension funds, private banks and college endowments.<sup>(9)</sup>

### Better avenues to value

Market observers warn that the private equity boom could be in the early stages of reversal. A combination of rising interest rates, shrinking liquidity, reduced lending, falling asset prices and rising default rates could expose the lack of fundamentals among the more recent players. In this scenario, investors might take the biggest hit. Many of these are pension funds and college endowments.

Perhaps many of the early private equity deals made sense for well-connected affluent investors and institutions. But now the industry seems like an expensive and complicated play on value stocks. There are more prudent ways to own value stocks through a diversified strategy that seeks to reduce risk exposure and manage costs. ■

## The Luck Window

Do active managers like volatile stock markets?

**R**ISING MARKET VOLATILITY during 2007 has prompted many investors to revisit a longstanding truth about stocks: they are riskier than bonds and cash.

We encourage clients to regard stock volatility as the normal state of the market—and low volatility as the exception. A structured, passive investment approach centers on managing the detrimental effects of volatility and capturing returns the markets offer for assuming systematic risks.

### Volatility as opportunity

In contrast to the passive view, the active management world regards market volatility as an opportunity. A recent white paper published by a prominent investment consulting firm sheds light on this view.<sup>(1)</sup> In short, active managers prefer higher volatility because it creates a window for speculation. The paper states that “large, short-duration drops in stock prices present buying opportunities for managers” while a relatively calm market typically reduces these opportunities.

The consulting firm analyzed the performance of money managers that concentrated their strategies in one of four major segments of the U.S. stock market (growth, value, large cap, and small cap) over two time frames—from 2001-2003 and 2004-2006. Performance in both of these three-year periods was compared to the market's average performance to determine how closely managers tracked the market.<sup>(2)</sup>

From the first to second period, all four market segments experienced an average 50% drop in their performance gap relative to the market. In essence, they produced returns 50% closer to the market when stock volatility dropped in the second performance period.

The implication appears to be that active managers need wide swings in stock performance to capture above-market returns as a group. Indeed, the author observed that the broad market dictates the trend that active managers often cannot escape.

While investors typically want to reduce their exposure to risk and smooth out the effects of volatility in their portfolios, the active management world apparently regards volatility as the means to shoot for higher returns. Although only a lucky few may achieve this, most active strategies expose investors to greater risks, higher costs and lower returns when compared to a passive portfolio strategy.

When the market enters a period of relative calm, the opportunity to make concentrated bets dissipates for the active manager. The luck window closes. Lower volatility results in even fewer active managers beating the broad market while also encouraging many of them to take more risk to differentiate their returns from the crowd. It appears that either market scenario may lead to higher risk taking.

### Capturing risks, managing costs

Academic research offers a wealth of evidence suggesting that, on average, active management does not pay for itself in any market. In most years, most active managers fail to match or exceed the returns offered from model portfolios with the same risk exposure, net of fees.

This white paper offers yet another example of why a structured, multifactor portfolio is the preferred strategy in declining markets, advancing markets, volatile markets and stable markets. Active managers may like volatility. But investors should embrace diversification and consider it a strategic partner in long-term wealth building.

A passive strategy strives to achieve more complete diversification and reduced risk exposure, while keeping management fees, transaction costs and tax impact low. These portfolio priorities can benefit investors in any market environment. ■

(1) “Manager Behavior in a Low Volatility Market”, Wilshire Associates Incorporated, 10 April 2007.

(2) The source of manager data was the Wilshire Compass database. The analyst considered 12-month rolling performance in comparing manager performance to the market during the two three-year periods.

