

THE BASICS OF
PRIVATE EQUITY INVESTING



MILES *Capital*

RESULTS THAT MATTER

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INTRODUCTION

Modern private equity investing traces its roots back to the 1940s, becoming more prominent when public pensions and endowments began making investments in the 1980s. Today it is regarded as an established alternative investment asset class utilized by many institutions.

Private equity firms look to acquire a significant debt or equity position in a company and seek to maximize that investment by growing the company, gaining operational efficiencies or restructuring.

Common concerns for private equity investors include the long-term illiquidity of invested capital, high fee levels and lack of transparency into underlying investments. Investors must weigh these concerns against their long-term objectives and growth goals.

POTENTIAL BENEFITS OF PRIVATE EQUITY

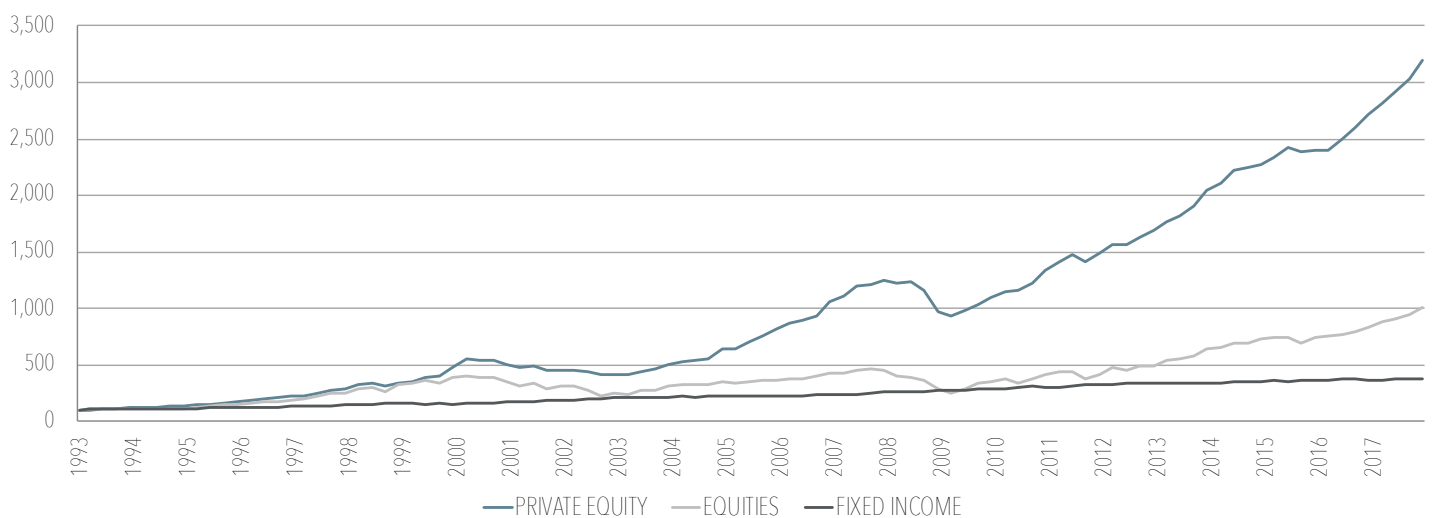
The opportunity set for private equity is vast and global, but most investors only directly invest into listed, public companies. An allocation to private equity enables greater reach and diversification.

Private equity returns are driven by strategic investments with the opportunity for significant growth. While investors must commit capital for a long period, the offsetting illiquidity premium may support annualized return targets of 300 to 500 basis points over public markets. Historically, private equity investments have resulted in outperformance relative to domestic, public markets.

While private equity valuations tend to directionally track public equity markets over time, the value of these investments is not subject to the same daily volatility public markets experience, which helps minimize losses in stress periods. Stability of returns is an important draw for institutional investors. Additionally, further diversification of equity exposures may result in lower volatility due to offsetting correlations with other traditional asset classes.

Private equity allocations have historically supported enhanced risk-adjusted returns over market cycles.

FIGURE 1: RETURN HISTORY SELECTED ASSET CLASSES 1996-2013, STARTING VALUE OF 100



Source: Bloomberg, Cambridge Associates, Miles Capital.

U.S. Equities represented by the S&P 500 Index, Private Equity is represented by the Cambridge Associate Private Equity Index, Fixed Income represented by Bloomberg Barclays Aggregate Index. Indices priced quarterly.

Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

Past performance is not a guarantee of future results.

HOW PRIVATE EQUITY WORKS

The most important distinction between public and private equity is that private investors are not simply passive value extractors. Private equity (PE) firms often actively manage the companies in their portfolios. PE firms create a portfolio or fund by purchasing significant interests in startups or established companies, then work to increase company value through reorganizations, enhanced operational efficiencies or external acquisitions. Value is typically realized through the sale of the company to a strategic or financial buyer, or through an initial public offering.

A fundamental characteristic of private equity is the long, illiquid nature of the investment. During the early years of the investment, PE firms earn management fees but investors typically do not realize any returns, a feature commonly referred to as the "J-curve." Managers may hold their investments from two to ten years between acquisition of a company and its sale. This long horizon results from the often deep structural changes PE firms make in order to increase the value of a firm. Strategic shifts and changes can take years to bear out the desired results.

Investing in private equity can be made at many stages of the company life cycle, and each has benefits and drawbacks. Diversified exposures to all types of private equity may offset many of the risks associated with each category.

Venture Capital

These are the investments in start-up and high growth companies, primarily across the health and technology industries. Venture Capital firms do not traditionally have controlling interest in the portfolio company, but instead work with company management to execute on strategy and develop business. These are typically higher risk, higher reward opportunities.

Buyout

Portfolio investments of this type often involve taking a significant or controlling stake in the company through some sort of buyout or restructuring transaction. These may involve the use of financial leverage and the goal is to enhance the growth and value of the firm. PE firms will actively manage company strategy, including product lines, acquisitions, and divestitures.

Distressed

These transactions involve investing into companies with distressed assets that may be improved through restructuring. Some companies may already be in default or bankruptcy and add value through debt restructuring and gaining operational efficiencies.

PRIVATE EQUITY STRUCTURE

Private equity investments are usually made through a fund structure, either a single fund or a fund of funds. Most single fund investments are in new funds, but a secondary market has developed. Direct investing, which commonly comes in the form of a co-

PRIVATE EQUITY	GROWTH
Form	Limited Partnership/LLC Typically 10-year structure
Characteristics	Long only investment Variety of strategies Commitments drawn over 3-5 years Majority income/gains realized years 5-10
Potential Benefits	Long-term returns over public equity Lower volatility than public equity Enhanced portfolio diversification Higher income in later years
Accounting	Reporting Schedules Gain/Loss Volatility Income realized as distributions made Taxed on activity of the fund via a K1
Capital	Capital charges similar to public equity

investment, is another option.

The traditional investment vehicle is a newly created limited partnership, whereby the general partner is the investment manager who oversees the portfolio and actively engages with the portfolio firms. As mentioned, these are illiquid investments and capital is committed at the outset to be called or drawn upon over three to five years. Distributions or returns of capital are made once value is realized from the underlying portfolio companies - often once companies are sold.

Investors who make co-investments purchase a direct stake in the company alongside, but independent of, the controlling fund. Often co-investors have strong relationships with PE firms and can access these deals through that relationship. They benefit from direct access to the underlying firms, greater control, and avoiding the cost of paying management fees. However, they require additional resources and expertise to perform the initial and ongoing due diligence.

Secondaries are purchases of existing private equity investments. Since private equity is

illiquid, initial investors may wish to exit their investment prior to fund liquidation - i.e. before the life cycle of the investment is complete. The secondary market exists to help investors exit their commitments and allows buyers to invest at a later stage, avoiding the early performance lag and allowing them greater insight into the portfolio. However, these investments typically result in lower returns than those held since inception of the fund.

A fund of funds structure invests in multiple single funds and might include both newly created funds as well as secondaries. This generally results in a fund that is broadly diversified across private equity managers. By nature, access to private equity can prove challenging. Private equity is highly stratified in terms of performance, with the top firms significantly outperforming their bottom quartile peers. Investment with elite managers is often unavailable or high barriers to entry exist. Through the pooling of resources and existing relationships with management companies, fund of funds can open doors that would otherwise be closed.

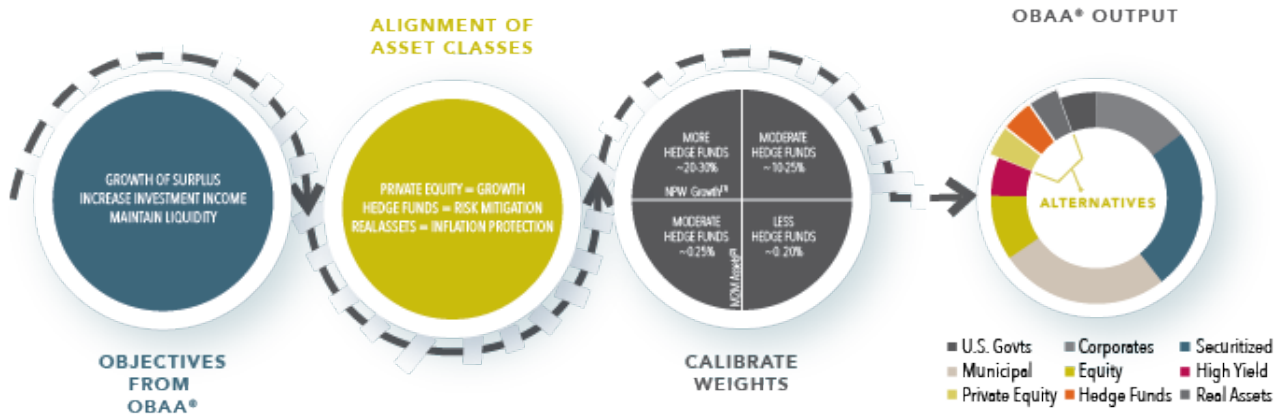
BUILDING AN ALLOCATION

Set Objectives: Asset Allocation

A company's unique business considerations do matter. For example, what is the capital budget and target? How volatile are the liquidity needs - are you over or under-allocated to liquidity? How much could you allocate away from yield-generating assets? There may be a significant opportunity to improve portfolio performance, but what objectives and constraints is the company most interested in meeting?

In the Objectives-Based Asset Allocation® framework (see Figure 2), private equity aligns most closely with the Growth objective. However, specific PE types, such as mezzanine debt or real asset investments also align with other objectives such as deflation or inflation hedging. Therefore, it is critical to understand your company's objectives and to what extent each of the objectives must be met. If premiums are expected to grow at 8 percent over the next 5 to 7 years, what assets will support that type of surplus growth? A diversified portfolio of buyout and venture capital funds is likely a good consideration. However, if the more pressing need is to offset the inflation impact inherent in your product line, then real assets may be more relevant.

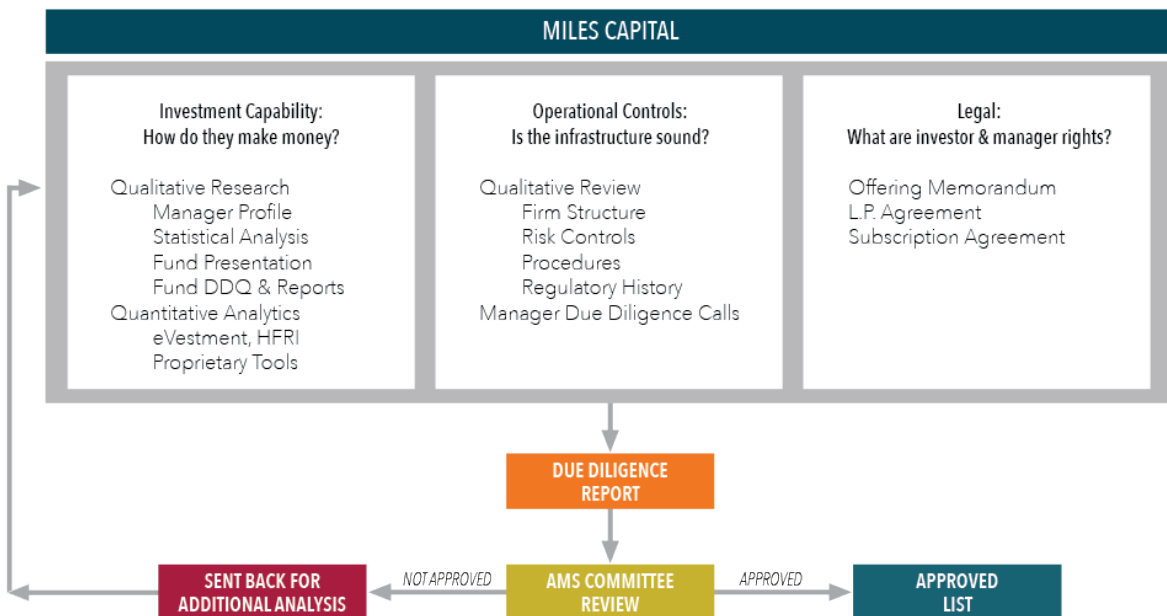
FIGURE 2: OBJECTIVES-BASED ASSET ALLOCATION®



Due Diligence Manager Selection

There are a number of considerations when selecting a private equity manager. As mentioned, return dispersion is quite high, so it is essential to be able to identify and access top-tier managers. Considerations include, but are not limited to the items listed in Figure 3.

FIGURE 3: MANAGER DUE DILIGENCE PROCESS



Diversification

Given the varied nature of private equity investment opportunities, diversification can be relatively easy to achieve at the right asset levels. Diversifying across stages or life cycles (venture capital vs. buyout) and investment types (primaries vs. secondaries)

helps deliver benefits, but investors can also diversify by managers and strategies, by industry, by geography, and by vintage year (funds raised in different years). Each level of diversification further helps support the ability to enhance the return potential without significantly altering the overall risk profile.

However, full diversification and direct investment programs do require significant capital to invest, which is a high barrier for many types of investors. For example, insurance companies are limited by regulatory and capital charge constraints. Pooling assets or investing in a fund of funds may help offset these and other restrictions.

Commitments and Drawdowns

When investing as a limited partner, investors “commit” a given amount of capital to a new fund. As the investment manager purchases portfolio companies, this commitment is gradually “called” by the general partners to fund the investments. This is called a “drawdown” structure - a commitment is drawn down over time. Given the long-term nature of these investments, market timing is relatively impossible.

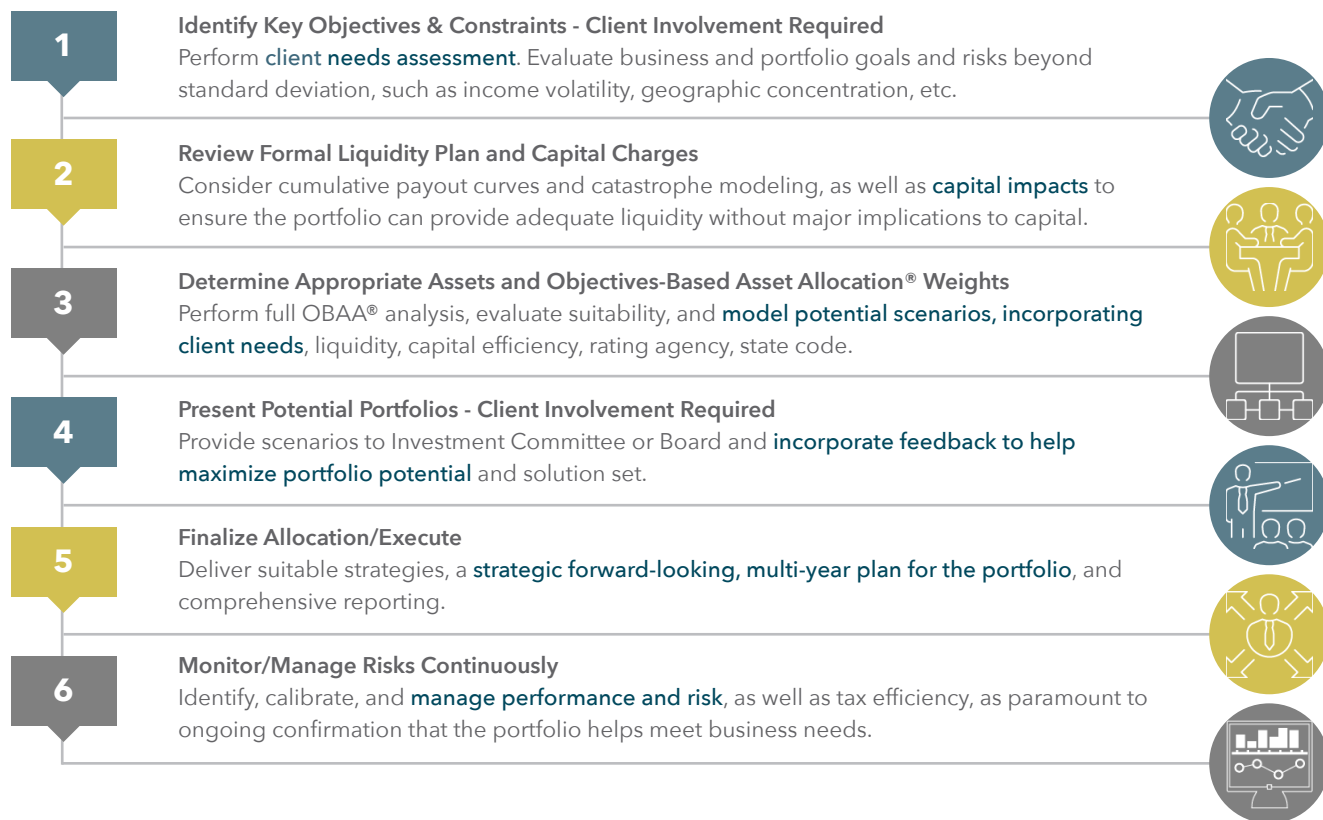
Once portfolio company targets are realized, capital is returned by divesting portfolio companies and distributing the proceeds back to the limited partners, which happens throughout the fund cycle. Due to the ongoing drawdown and return of capital, as well as the inability to time future investments, it is important to be patient and consistently invest per your objectives, committing additional capital on an ongoing basis.

MILES CAPITAL AND PRIVATE EQUITY INVESTING

The conventional approach to investing in private equity is to allocate product-by-product. Many managers approach investors on the basis of their strategy’s standalone appeal. However, this approach may compound risk levels and not achieve the expected benefits.

In contrast, Miles Capital helps clients allocate to private equity and other alternative assets within the context of a strategic framework, whereby each investment serves to complement or enhance the existing risk profile. We have crafted a process that tailors alternative allocations for clients based on our Objectives-Based Asset Allocation®:

FIGURE 4.0 INTELLIGENT DESIGN: MILES CAPITAL’S PROCESS STARTS WITH THE CLIENT



This framework is based on our robust manager selection processes. And, our strategic industry partnerships lower the barriers to entry for our clients and support well-diversified portfolios. Miles Capital offers investors and entities a different kind of advice, an intelligently-designed asset allocation process, and a turnkey alternatives platform.

The universe of asset classes is complex. We leverage our experience, alternatives knowledge, and industry partnerships to bring our clients clear, customized solutions, all offered in a powerful easy-to-use package.

Conclusion

Changing political headwinds, an easing of federal regulatory oversight, and increasingly volatile environmental patterns have set up the financial sector for a period of significant change moving forward over the next year. At the same time, economic fundamentals remain conducive to growth, buoyed by corporate tax reductions. The lasting impact of these changes in the banking and insurance industries will differ significantly by sector and investor type and warrant close attention as this new chapter in the financial sector narrative unfolds.

CONTACT US TODAY AT 800.343.7084 FOR MORE INFORMATION.

ABOUT MILES CAPITAL

Investing for institutions requires a deep knowledge of the objectives, parameters, and regulatory constraints faced. And, each client is unique. At Miles Capital, we offer customized investing and relationships directly with portfolio management to help meet these needs. We take a holistic view of our clients' needs, and build strategic partnerships that help support their broader goals.

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