As investors in NAIC member firms: minority and diverse private equity firms and those focused on the U.S. Emerging Domestic Market, the members of the Fund of Funds Working Group are pleased to present Recognizing the Results, an in-depth analysis of the financial returns and investment performance of these diverse, pioneering and innovative firms.

The financial performance of private equity mega funds is well-documented and the focus of nearly daily media attention. In contrast, smaller private equity funds, particularly those managed by diverse and minority investment professionals focused on the middle market and the U.S. Emerging Domestic Market (“EDM”), receive minimal attention. Consequently, investors like public employees with retirements at stake and investment professionals managing billions for pension funds, labor unions, corporate plans, philanthropies and universities may be missing out on opportunities to generate significant returns.

We would like to acknowledge Timothy Bates, William Bradford, Julia Sass Rubin, Gregory Fairchild and The Boston Consulting Group, whose prior research cogently identified enduring inequities and structural barriers to greater commitments of investment capital to this sector. Building on their foundational work, this proprietary performance study of NAIC’s private equity investment managers breaks new ground by benchmarking their performance against the general private equity industry.

The findings of this report conclusively affirm the tangible benefits investors may realize by investing capital in minority and diverse private equity firms that remain largely overlooked by institutional investors.

We would like to thank the National Association of Investment Company (NAIC) member firms that participated in this effort. Their submissions yielded a rich and detailed portrait and analysis of their performance.

Sincerely,

FUND OF FUNDS WORKING GROUP
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By performing an in-depth analysis of the financial performance of the NAIC General Partner firms that participated in the survey ("NAIC Firms"), **Recognizing the Results** captures a representative sample of the larger sector of diverse and minority private equity firms and those focused on the EDM.

The benchmarked performance period surveyed is 1998–2011. The industry benchmarks applied for all U.S. Private Equity ("PE") and the U.S. Buyout subset are: Thomson Reuters Capital Weighted, Median and Upper Quartile Returns; Capital Weighted Distribution to Paid-in Investment; and 1998 through 2010 Capital Weighted and Upper Quartile Vintage Year Returns.

**NAIC Firms produced superior returns to the U.S. PE Benchmark and the U.S. buyout subset**

The findings of **Recognizing the Results** show that NAIC Firms have produced superior investment returns over a sustained period benchmarked against the general PE industry, including the buyout subset. As the chart below summarizes, NAIC Firms outperformed the PE industry including the buyout subset in each of the four (4) industry benchmarks.
PERFORMANCE ANALYSIS SUMMARY

An analysis of NAIC Firms by investment professionals with significant experience investing fund of funds mandates in this sector (“Fund of Funds Working Group”) identified contributing factors common to NAIC Firms’ superior performance.

NAIC Firms demonstrated:

1. Disciplined adherence to investment theses, followed by better entry purchase terms including price in unique investments sourced through proprietary deal flow networks;
2. Emphasis on applying operational improvements in portfolio companies;
3. Investments in opportunities tied to rapidly changing demographics reshaping the U.S. economy; and
4. Profound personal and professional motivations to succeed including putting relatively greater amounts of their net worth and compensation at risk and a focus on a single investment platform, both of which more closely align with the interests of limited partners (investors).

DEMOGRAPHIC SUMMARY

NAIC Firms represent a diverse range of investment strategies and focus. What these firms have in common are ownership groups and investment professional teams that are significantly more diverse than the general PE industry.

The average fund managed by NAIC Firms was $156.3 million, significantly smaller than the general PE industry average fund size of $469 million

1. The diversity of NAIC Firms exceeds the general PE industry with minorities owning 50% or more of eleven of the fourteen firms (78.57%) and 69.23% of firms having investment operations with at least 50% women or minority investment professionals.
2. NAIC Firms comprise approximately $7.2B in collective assets under management (“AUM”), which represents 0.24% of the entire PE market.
3. The participating fourteen NAIC Firms represent 94.78% of the capital managed by all NAIC General Partner member firms as of December 31, 2011.
4. These fourteen NAIC Firms represent 82.35% of all NAIC General Partner member firms as of December 31, 2011.
5. As of December 31, 2011, NAIC AUM ranged from $100 million to $2.5 billion with a median AUM of $330 million. The average fund managed by NAIC Firms was $156.3 million, significantly smaller than the
general PE industry average fund size of $469 million.  

6. The majority of NAIC Firms launched between 2003 and 2010 have raised an average of 2.4 funds per firm.
7. Among NAIC Firms, 8 of 14 focus on buyout strategies, with an average of 13 portfolio companies per fund.

IMPLICATIONS

Despite the superior financial performance of NAIC Firms over a sustained period, the significant majority of institutional investors including public pension funds, corporate pension plans, university endowments and philanthropies do not invest capital in diverse and minority private equity firms or those focused on the EDM.

This lack of investment capital is attributable to a number of challenging industry factors, including:

1. **Reduction in the number of investment managers**: Since 2008, many institutional investors have reduced their internal staffs and focused on reducing management fees by concentrating their investments with fewer, larger PE firms.
2. **Reliance on investment consultants**: Institutional investors often rely on investment consultants to manage their investment selection process. These consultants are most often likely to recommend larger and more established managers whom they perceive to carry less risk because of their longevity and brand recognition.
3. **Limited marketing resources of smaller firms**: NAIC Firms are newer with smaller AUM and many do not have sufficient revenue streams to invest in building dedicated marketing teams.

RECOMMENDATIONS

Even as a clear body of research confirms the financial performance of minority and diverse firms frequently exceeds returns of the broader private equity market, many of the largest public and private institutional investors have yet to include these firms in their portfolios.

**Recognizing the Results** sheds light on key best practices to address the imperative of investing greater capital in this consistently outperforming segment of the PE industry.

Institutional investors should:

1. Consider investment mandates to direct capital to diverse and minority private equity managers and those focused on the EDM;
2. Establish fund of funds vehicles to gain initial exposure to these managers and invest larger direct investments to benefit from the strong financial returns produced by diverse and minority private equity managers and those focused on the EDM;
3. Monitor relationships with investment consultants and track how diverse and minority private equity managers

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1 Preqin, July 2012.
are identified and recommended; and
4. Establish direct relationships with diverse and minority investment managers by participating in the industry organizations that support them, such as NAIC (naicpe.com), and attending conferences and events.

**Recognizing the Results** is a compelling fact-based analysis of the performance of diverse and minority private equity managers, and a thoughtful assessment of the enduring challenges this high-performing sector of private equity faces gaining fair access to greater institutional investment capital. The performance analysis and market assessment captured in **Recognizing the Results** present significant immediate and longer-term opportunities for investors seeking superior returns.
Recognizing the Results is the product of six months of collection, compilation and analysis of performance data submitted by General Partner member firms of NAIC. The financial returns of a representative sample of diverse and minority private equity firms and those focused on the EDM, presented in Recognizing the Results, serves as a proxy for the broader sector as a whole. The collected performance data was based on firms’ 2011 year-end audited financial statements.

To capture data necessary to benchmark performance against industry metrics, performance data templates were designed by the Fund of Funds Working Group and approved by an NAIC subcommittee overseeing this project. Numerous qualitative and quantitative variables for firms, funds and portfolio companies were incorporated into the templates.

To ensure objectivity and transparency, NAIC engaged KPMG LLP (“KPMG”) the global audit, tax and advisory firm, to manage collection and compilation of the performance data. NAIC Firms sent their completed performance data directly to KPMG, which removed individual firm attribution and aggregated the data. KPMG provided the Fund of Funds Working Group with non attributed aggregated performance data templates without identifiable information. Throughout the process, the identities of NAIC Firms remained confidential to KPMG.

NAIC Firms that submitted performance data templates to KPMG constitute 94.78% of AUM of NAIC’s General Partner member firms as of December 31, 2011. This participation represents 82.35% of NAIC’s General Partner member firms as of December 31, 2011. Fourteen NAIC Firms submitted demographic data and thirteen NAIC Firms submitted financial performance information based on their year-end audited financials as of December 31, 2011. This data included the financial performance of 26 funds on a median, capital weighted, distribution to paid-in investment and vintage year basis. Because of the relatively small number of NAIC Firms with funds pre-dating 1998, these funds were excluded from the returns analysis and the vintage return comparisons.

Similarly, because funds recently launched in 2011 or later are still of indeterminate success, they too were excluded from the median returns analysis. All funds were included in the capital weighted average returns analysis whereby returns were weighted by the size of the firm and the size of fund. To compare performance, the Fund of Funds Working Group benchmarked the data templates against relevant Thomson Reuters’ (formerly Venture Economics) PE industry benchmarks. The following PE benchmark metrics were applied:

1. Thomson Reuters Capital Weighted, Median and Upper Quartile Returns of All U.S. Private Equity for funds 1998–2011 excluding year 2002 (since NAIC did not have a fund of this vintage year.)
2. Thomson Reuters Capital Weighted, Median and Upper Quartile Returns of U.S. Buyout for funds 1998–2011 excluding year 2002 (since NAIC did not have a fund of this vintage year.)
PERFORMANCE FINDINGS

NAIC Firms’ Investment Returns Outperformed the PE Industry
The cumulative median net internal rate of return (“IRR”) and multiple on invested capital (“MOIC”) of NAIC Firms was 15.2% and 1.52x for the period 1998-2011. Compared against Thomson Reuters’ Venture Economics benchmarks, NAIC Firms’ performance was superior to the upper quartile performance of the broader PE market. Using the same benchmark, NAIC Firms’ median IRR return was also above the upper quartile of the buyout subset of the PE market for the period.

<table>
<thead>
<tr>
<th>Year-End Benchmarks</th>
<th>Metric</th>
<th>Capital Weighted</th>
<th>Median</th>
<th>Upper Quartile</th>
</tr>
</thead>
<tbody>
<tr>
<td>All U.S. Private Equity</td>
<td>Net IRR</td>
<td>6.5%</td>
<td>3.7%</td>
<td>11.8%</td>
</tr>
<tr>
<td></td>
<td>Net MOIC</td>
<td>1.24x</td>
<td>1.11%</td>
<td>1.42x</td>
</tr>
<tr>
<td></td>
<td>DPI</td>
<td>52.2%</td>
<td>29.0%</td>
<td>67.1%</td>
</tr>
<tr>
<td>U.S. Buyout</td>
<td>Net IRR</td>
<td>8.3%</td>
<td>7.1%</td>
<td>14.7%</td>
</tr>
<tr>
<td></td>
<td>Net MOIC</td>
<td>1.34x</td>
<td>1.32x</td>
<td>1.59x</td>
</tr>
<tr>
<td></td>
<td>DPI</td>
<td>61.6%</td>
<td>51.8%</td>
<td>89.1%</td>
</tr>
<tr>
<td>NAIC Firms</td>
<td>Net IRR</td>
<td>27.5%</td>
<td>15.2%</td>
<td>20.9%</td>
</tr>
<tr>
<td></td>
<td>Net MOIC</td>
<td>1.88x</td>
<td>1.52x</td>
<td>1.99x</td>
</tr>
<tr>
<td></td>
<td>DPI</td>
<td>107.9%</td>
<td>70.2%</td>
<td>160.0%</td>
</tr>
</tbody>
</table>


On a Median and Capital Weighted Basis, NAIC Firms’ IRR Performance Was Superior to the Upper Quartile of the PE Market and Buyout Subset

To provide a better understanding of the performance of all funds of NAIC Firms, returns were analyzed on a capital weighted basis at the firm and fund levels. As the following chart illustrates, the capital weighted net IRR and multiple for NAIC Firms were 27.5% and 1.88x, respectively. The capital weighted performance of NAIC Firms was well above upper quartile for both the broader PE market and the buyout subset.


<table>
<thead>
<tr>
<th>Domain</th>
<th>Metric</th>
<th>Investment Cap Weighting</th>
<th>Net IRR%</th>
<th>Net MOIC</th>
<th>DPI</th>
</tr>
</thead>
<tbody>
<tr>
<td>NAIC Firms</td>
<td>Capital Weighted</td>
<td>NAIC</td>
<td>27.5%</td>
<td>1.88x</td>
<td>107.9%</td>
</tr>
<tr>
<td>Thomson Reuters All U.S. PE</td>
<td>Capital Weighted</td>
<td>NAIC</td>
<td>6.5%</td>
<td>1.25x</td>
<td>52.2%</td>
</tr>
<tr>
<td>Thomson Reuters All U.S. PE</td>
<td>Pooled Average</td>
<td>NAIC</td>
<td>7.0%</td>
<td>1.26x</td>
<td>54.0%</td>
</tr>
<tr>
<td>Thomson Reuters All U.S. PE</td>
<td>Upper</td>
<td>NAIC</td>
<td>11.8%</td>
<td>1.42x</td>
<td>67.1%</td>
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<tr>
<td>Thomson Reuters All U.S. PE</td>
<td>Median</td>
<td>NAIC</td>
<td>3.7%</td>
<td>1.11x</td>
<td>29.0%</td>
</tr>
<tr>
<td>Thomson Reuters All U.S. Buyout</td>
<td>Capital Weighted</td>
<td>NAIC</td>
<td>8.3%</td>
<td>1.34x</td>
<td>61.6%</td>
</tr>
<tr>
<td>Thomson Reuters All U.S. Buyout</td>
<td>Pooled Average</td>
<td>NAIC</td>
<td>8.9%</td>
<td>1.36x</td>
<td>63.0%</td>
</tr>
<tr>
<td>Thomson Reuters All U.S. Buyout</td>
<td>Upper</td>
<td>NAIC</td>
<td>14.7%</td>
<td>1.59x</td>
<td>89.1%</td>
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<td>Thomson Reuters All U.S. Buyout</td>
<td>Median</td>
<td>NAIC</td>
<td>7.1%</td>
<td>1.32x</td>
<td>51.8%</td>
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Note: Two methods of capital weighting were assessed: (1) Weighted by NAIC amount invested and (2) Weighted by Thomson Reuters' universe of invested capital of all sample funds.

The following graphs present the strong financial performance of NAIC Firms benchmarked against the broader PE industry and the buyout subset on a median and capital weighted basis. By both benchmarks, NAIC Firms outperformed the upper quartile of the PE industry including the buyout subset.


**NAIC Firms Significantly Outperformed the PE Industry Returning Capital to Investors**
Distributions from Paid-In investments of NAIC Firms further demonstrate their out performance compared to the general PE market. From 1998 through 2011, the distributions to investors by NAIC Firms on a capital weighted basis (“DPI”), was 107.9% versus the general PE market capital weighted DPI of 52.2% and U.S. buyout capital weighted DPI of 61.6%.

This finding also suggests that while NAIC Firms have smaller AUM, they consistently have been more efficient in generating returns faster than firms with larger AUM.

Based on performance benchmarked by vintage year, NAIC Firms were upper quartile on a net IRR basis in 75% of the investment period, or all but three of the vintage years in the period 1998-2010.
The strong financial returns and superior investment performance of NAIC Firms are not a revelation to the Fund of Funds Working Group and other institutional investors active in this sector. Past research has similarly found that firms comparable to these NAIC Firms achieved competitive financial returns and in some cases returns better than those generated by broader PE industry funds.

In 2008, Bates and Bradford, who have a long and distinguished history of writing about the financial returns of the industry, found that the internal rate of return on investments undertaken by a sample of minority-oriented venture capital funds invested after 2001 and realized by year-end 2006 was 29.1%. This research also found that minority-oriented funds achieved stronger returns than the NASDAQ and S&P during most of the period of this study. An earlier study produced by those authors and Julia Sass Rubin in 2006 characterized the state of the minority venture capital industry in 2000 as “thriving” and “profitable.”

In “Minors in Venture Capital: A New Wave in American Business,” written by Bates and Bradford in 2003, the authors measured private equity investments of minority-oriented venture funds made during 1989-1995 and realized by year-end 2000. This study found that the mean IRR of those funds was 23.9%. The positive results over two decades as noted by Bates and Bradford confirm that strong financial performance by minority and emerging private equity managers is sustainable. The findings of Recognizing the Results suggest that superior financial performance of NAIC Firms is scalable.

**POTENTIAL SUCCESS FACTORS**

The survey data and the Fund of Funds Working Group’s significant experience investing in this sector of the market unearthed key factors contributing to the strong performance of NAIC Firms:

1. **Purchasing Discipline/Lower Prices:** Because of fund sizes that are smaller than the general PE market, NAIC Firms exercise an abundance of discipline and prudence making investments. Given the relatively smaller size of their portfolio companies, NAIC Firms typically have less access to

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debt markets, which further drives down the prices they are able pay for portfolio companies. This
diligence also reveals that NAIC Firms tap into proprietary business networks and relationships
to source unique companies with high-growth potential in emerging and less-understood sectors
not always covered by investment bankers. The resulting transactional opportunities are typically
less competitive than the general PE market, leading to more favorable terms for NAIC Firms.

2. Opportunities for Improvement: Because the underlying portfolio companies tend to
be smaller and less likely to be operationally mature at the time of purchase, they provide
a number of opportunities for material improvement by NAIC Firms. These enhancements
often include upgrades to accounting, software systems and management talent.

In “Equity Capital in the Emerging Domestic Market and Its Critical Role in Driving Growth in the
Broader US Economy,” written by The Boston Consulting Group on behalf of NAIC in 2009, the
authors posited that the discipline of private equity, when successfully undertaken, can provide
portfolio companies with access to needed capital, upgrade and expand the depth of management,
enhance operational efficiencies and broaden networks of relationships. These are significant
advantages that most of the portfolio companies did not have until NAIC Firms invested in them.

In Bates and Bradford’s 2003 study, regression analysis established that higher IRRs
were associated with “venture capital general partners being actively involved with their
portfolio companies.” Due diligence performed by the Fund of Funds Working Group
on many of the NAIC Firms over an extended period of years confirms that NAIC Firms
tend to be very active in providing post-investment value-add to their portfolio companies.

3. Changing demographics: Due to the rapidly changing ethnic demographics reshaping the
United States as captured in the U.S. 2010 Census, a compelling business case exists for PE firms
investing in opportunities tied to these shifts. These economic sectors and the companies in them
tend to be less expertly understood by general market investment bankers, which presents greater
potential purchasing advantage for investors. Due diligence conducted by the Fund of Funds Working
Group on NAIC Firms and similar PE firms strongly indicates that firms focused on the EDM have
proprietary deal flow access into companies tied to the changing demographics reshaping the economy.

4. Alignment of interest with limited partners: Since most NAIC managers are on one
of their first three funds, and in some cases on one of their first two funds, their AUMs tend to be
smaller compared to the general PE market. Given their size, these managers do not yet have the
benefit of substantial economics, including carry and management fees from multiple funds that
provide significant income. The current funds operated by NAIC managers represent a significant
portion of their income and net worth and constitute uniquely compelling motivation to succeed.

Similarly, the total focus of NAIC managers on a single investment platform is in contrast to general
market PE managers concurrently raising multiple funds across several investment platforms, and some
who are publicly traded. Risking their own net worth combined with the enduring challenges specific to
minorities accessing capital represent a set of motivations to succeed which closely align with interests
of limited partners.


NAIC firms participating in this survey represent 94.78% of AUM of NAIC’s General Partner members as of December 31, 2011. Overall, 82.35% of NAIC’s General Partner members as of December 31, 2011 participated. The NAIC firms had $7.2B in collective assets under management as of December 31, 2011, comprising approximately 0.24% of the entire private equity market. According to Prequin, at year-end 2011 $3 trillion was managed by PE funds, a 9% increase over 2010.

NAIC firms demonstrate a wide variety of characteristics including tenure, investment strategies, sources of capital and AUM. However, what NAIC firms have in common is significant ethnic minority ownership. Most investment staffs are comprised of at least 50% women or ethnic minorities, with several NAIC firms being 100% women or minority. Many NAIC firms fall within the definition of the U.S. emerging domestic market (“EDM”) developed by Gregory Fairchild, Associate Professor of Business at the University of Virginia Darden School of Business. Fairchild’s definition of EDM includes the following criteria:

1. Owners are ethnic or racial minorities,
2. Company locations are in urban areas,
3. Customers are ethnic or racial minorities, and
4. Employees are ethnic and racial minorities.

NAIC firms all satisfy at least one of these criteria, with most meeting two or more. Beyond a focus on the EDM among many, NAIC firms more broadly reflect divergent market characteristics across investment strategy, human capital and composition of investment teams.

The longest-tenured NAIC firm was founded in 1977, while the newest firm was launched in 2010. Several firms were founded in the 1990s, with most launching between 2003 and 2010. The chronology of participating firms is consistent with the broader evolution of the minority investment industry. According to Timothy Bates of Wayne State University, William Bradford of Washington University and Julia Sass Rubin of Harvard Business School, the minority investment industry started in the 1970s and then grew quickly in the 1990s, and along with it the category of minority-owned firms.

While formed decades earlier, the general private equity industry also experienced notable growth in the 1990s, as reflected in the next graph. While NAIC firms are newer relative to the general PE market, the longevity differential is not materially large enough to account for the significant gap in AUM between NAIC firms and the general PE market.

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7 As of December 31, 2011 and according to the capitalization figures member firms have provided to NAIC. These figures do not include the capital managed by NAIC’s fund of funds members or NAIC General Partners who were not members of NAIC when this project started.
9 NAICPE.com.
Among NAIC Firms, the average number of portfolio companies per fund is 13.0
INVESTMENT STRATEGIES

NAIC Firms represent the full array of investment stage strategies including venture, growth, buyout and special situations. The largest group, those focused on buyout strategies, represented 57.1% of NAIC Firms. Most invest in companies in the lower-middle market, typically defined as having annual revenues up to $250 million. Special Situations investing was the least pursued strategy by participating NAIC Firms, with 7.1% targeting such opportunities.

![Funds by Investment Stage](image)

Most NAIC Firms focus on companies based in the United States, though some invest globally. The industries targeted by NAIC Firms include a diverse range of sectors like communications, media, software, natural resources, industrial manufacturing, business services, consumer products and technology.

Reflecting their EDM investment focus, several NAIC Firms target companies with growth tied to the country’s rapidly changing consumer demographics and ethnically diverse companies located in fast-growing urban areas.

HUMAN CAPITAL

NAIC Firms on average consist of roughly 4 partners and 8 investment professionals. The range of investment professionals spanned from 1 to 15, while the number of partners ranged from 2 to 9. Compared to the general PE industry, NAIC Firms have smaller investment teams and fewer partners.

In 78.57% of NAIC Firms, minorities own 50% or more of the firm. 100% of NAIC Firms have minority

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12 Figure based on the data provided by 13 participating NAIC firms.
owners with at least a 33% stake in the firm’s economics. Investment professionals at NAIC Firms also reflect gender diversity with 69.23% having investment operations in which at least 50% of the investment professionals are women or minorities.\(^{13}\)

The ethnic diversity of NAIC Firms exceeds the general PE industry. Although scant research exists on diversity in PE, a report published by the U.S. Government Accountability Office in 2010 cited the Equal Employment Opportunity Commission finding that ethnic minorities held only 10.0% of senior positions in the financial services industry as of 2008. The same study showed that white males held 64.0% of those positions, African Americans held 2.8%, Hispanics held 3.0% and Asians held 3.5%.\(^{14}\)

A recent article by Dan Primack on Fortune.com further substantiated these statistics with research estimating that African American men appear to represent less than 10% of the total PE professional workforce.\(^{15}\) These sources show that NAIC Firms comprise ethnic diversity that is several multiples higher than prevailing rates in the investment industry and, in particular, private equity.

**SOURCES OF CAPITAL**

NAIC Firms derive their capital from various sources including public pension funds, family offices, endowments, fund of funds and corporate pensions.\(^{16}\) Virtually all of the firms secured a material portion of their capital from public pension funds, particularly if it can be assumed that a significant percentage of the capital invested by fund of funds investments in NAIC Firms comes from public pension funds. As noted in the chart below, on average NAIC Firms received 70% of capital from funds of funds (36%) and pension plans (34%).

Beyond funds of funds and public pension funds, corporate pensions represent another source of capital, comprising 12% of participating NAIC Firms’ assets under management. Philanthropic endowments, university pension funds and private family offices invested relatively small amounts of capital in NAIC Firms.

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\(^{13}\) 13 of the 14 funds provided this data.


\(^{15}\) Primack, Dan. “Private equity is a man’s world... seriously.” Fortune.com. February 8, 2011.

\(^{16}\) Figures here are based on data provided by 12 of the study’s 14 participating firms.
The gap between AUM of NAIC Firms and the average PE fund as measured by Preqin suggests that institutional investors have yet to fully appreciate and embrace opportunities to invest in minority managers despite their competitive performance.
As recently reported by Dow Jones Private Equity Analyst in its August 2012 cover story, despite impressive track records of performance, raising capital remains a challenge for many minority private equity managers. The gap between AUM of NAIC Firms and the average PE fund as measured by Preqin suggests that institutional investors have yet to fully appreciate and embrace opportunities to invest in minority managers despite their competitive performance.

Due to this enduring reality, a number of NAIC Firms have entered into agreements with outside investors and strategic partners who have invested considerable capital in their funds in exchange for participation in the funds’ economics. Among six NAIC Firms that traded participation in their fund economics for capital investments, strategic investors own 10% to 50% of the fund, with most between 25% and 35%.18 Due diligence performed by the Fund of Funds Working Group indicates that in addition to capital, NAIC Firms also receive important fund formation resources like strategic advice, back office support, office space and reduced operating expenses.

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18 Strategic partner information was submitted by 13 of the 14 firms.
Recognizing the Results captures the richness of the diverse and minority private equity market across broad quantitative and qualitative metrics. The oldest NAIC firm was formed over three decades ago, while the youngest of firms launched barely two years ago. A number of surveyed firms have entered into strategic partnerships to increase their capital bases. For all their pioneering accomplishments in PE, these firms have produced positive individual and collective track records of investment performance over a sustained period.

At the same time, the financial outperformance benchmarked against the general PE market captured in this survey raises a number of implications for additional discussion and, we hope, immediate and active engagement by institutional investors:

1. Measured against key benchmarks, NAIC Firm performance exceeded the broader PE market including the buyout subset. Both the median net IRR and median multiple on invested capital of NAIC Firms outperformed the upper-quartile of the broader PE market. By vintage year, NAIC Firms were upper quartile on a net IRR basis in all but three of the years, or 75% of the investment period 1998 to 2010. Despite outperforming the PE market over a sustained period, NAIC Firms still only manage 0.24% of private equity market assets.

2. On a capital weighted basis, the net IRR of NAIC Firms and their funds and the multiple on invested capital both outperformed the upper quartile of the PE market and the buyout subset. Based on actual distributions to investors, NAIC Firms’ capital weighted DPI (Distributions from Paid-In Investments) outperformed PE capital weighted DPI and U.S. buyout DPI. The majority of public pension funds, corporate pension funds, university endowments and philanthropies do not invest in minority managers whose financial returns outperform the general PE market.

3. Since 2008, many institutional investors have reduced the number of private equity managers they invest in to cut costs and capture discounted management fees by concentrating larger investments with fewer managers. The capital concentration trend in the PE industry presents an immediate challenge to high-performing smaller, diverse and minority firms.

4. Many institutional investors rely on investment consultants to manage their investment selection process. Investment consultants are most likely to recommend larger established firms that they perceive carry less risk due to longevity and brand recognition.

Measured against key benchmarks, NAIC Firm performance exceeded the broader PE market including the buyout subset
Despite superior performance, the fact that NAIC Firms collectively managed only 0.24% of total private equity assets at year-end 2011 is a sobering reality check. As the trade association representing women, diverse and minority private equity managers, we believe these findings warrant immediate attention and action by investment policymakers, public employees, unions, legislators, the media and most of all, fund trustees with fiduciary responsibility to their investors.

As institutional investors and other key stakeholders begin to address the issues presented in Recognizing the Results, the following best practices can be adopted to realize benefits in the short term.

1. Institutional investors not currently investing with diverse and minority private equity managers, particularly those managing capital on behalf of diverse investor populations, should consider investment mandates to gain exposure to this outperforming sector of the market.

2. Institutional investors currently investing with diverse and minority private equity managers through fund of funds programs should consider establishing dedicated follow-on investments to allocate materially larger amounts of capital directly to managers in this sector of the market.

3. Institutional investors should review their consultant relationships to ensure that consultants are identifying, tracking and recommending diverse and minority private equity managers and those focused on the EDM.

4. Institutional investors should establish direct relationships with diverse and minority private equity managers by participating in the National Association of Investment Companies and other industry organizations dedicated to promoting greater capital access, transparency and performance-based criteria on behalf of diverse, minority and emerging manager firms.

Recognizing the Results is a compelling fact-based analysis of the superior performance of diverse and minority private equity managers. These findings provide a thoughtful assessment of the enduring obstacles to larger institutional investment commitments to this high-performing sector of private equity. The performance analysis and market assessment captured in Recognizing the Results represent significant immediate and long-term opportunities for investors seeking superior returns.

... these findings warrant immediate attention and action by investment policymakers, public employees, unions, legislators, the media and most of all, fund trustees with fiduciary responsibility to their investors
ACKNOWLEDGEMENTS

The NAIC was established 42 years ago as a trade association representing the interests of minority-owned investment companies. Today, we represent diverse, women and minority private equity managers and those investing in the U.S. Emerging Domestic Marketplace.

Throughout our rich history, NAIC member firms have invested in high-growth companies in the middle market across industries including business services, healthcare, infrastructure, natural resources, software, industrial manufacturing, consumer services and technology. NAIC members help to build stronger, nimble companies by fostering growth through investments that produce superior returns for investors in addition to creating economic impact and job creation.

By virtue of their demographic composition and investment focus, NAIC General Partner member firms constitute a representative sample set of this important segment of private equity. Recognizing the Results was commissioned to raise greater awareness among investors about the compelling financial performance of diverse and minority private equity managers and those investing in the U.S. Emerging Domestic Market. We hope these findings will spur immediate dialogue and action by key legislative, investment policy and fiduciary decision makers so that greater allocations of capital are invested with diverse and minority private equity managers and those focused on the U.S. Emerging Domestic Market.

We would especially like to thank KPMG and Stephen Hicks for their critical support and leadership in managing the collection and compilation of the performance data.

We are deeply grateful to the members of the Fund of Funds Working Group for contributing their significant investment expertise, analytical diligence and intellectual capital to this comprehensive report. We would like to thank:

- Rebecca Connolly, Fairview Capital
- Matt HoganBruen, BAML Capital Access Funds
- Derek Jones/David Weissman, Credit Suisse Customized Fund Investment Group
- Charles Willis, JP Morgan Asset Management
- Patricia Miller Zollar, Neuberger Berman

A note of thanks is in order for Ed Dandridge, President & CEO of NAIC, and the NAIC staff. In particular, Jennell Lynch and Dawn Simmons are deserving of special recognition.

We believe Recognizing the Results’ findings will lead to an informed discussion in the investment industry about the merits of these managers and the imperative of increasing capital to high-performing diverse and minority firms that are producing strong financial returns and reflect the rapidly changing demographics of the 21st century economy.

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The views, analyses and opinions reflected herein, unless expressly stated otherwise, reflect the perspective of NAIC and the Fund of Funds Working Group and do not necessarily state or reflect the views of third parties, including employers of the members of the Fund of Funds Working Group.
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