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Private-Equity Funds Head for Banner Year

By MURRAY COLEMAN

Managers of private-equity funds are taking advantage of low interest rates to finance new deals at the fastest pace in five years, and an increasing number of investors are trying to get in on the deals.

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One recent survey signals a particularly high level of involvement by wealthy younger investors, though in terms of understanding the risks involved, there may be no substitute for experience.

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"This is a real potential minefield," says John Bird, co-founder of Albion Financial Group, an investment advisory firm in Salt Lake City, with about $750 million in assets. "One in 10 of these private-equity deals might earn enough to make it worthwhile for someone, and the others can easily blow up if investors aren't careful."

Private-equity funds have raised $304 billion so far this year, as of Monday. That is the industry's best nine-month total since a record 2008, according to industry tracker Preqin. The funds typically operate as partnerships, buying and selling private companies or other assets not usually traded on exchanges.

"The Federal Reserve's decision not to taper its economic stimulus program is good news for the private-equity market," says Brad Stratton, an adviser in Overland Park, Kan., with $150 million in assets.

Since it is likely to keep the costs of borrowing down for longer, sticking to current policies should prove a net positive for riskier assets such as private-equity funds, he says.

But not everyone can get into private-equity funds, which must meet accredited-investor rules and usually limit participation to those with a net worth of $1 million or more and with high annual incomes. Fees can also rival hedge funds, with 2% going for fund management in the initial five years and 20% lopped from any profits once 8% in returns is reached.

Still, an estimated 8.7 million U.S. households could be considered as accredited investors under current regulatory guidelines, points out Brad McGee, founding partner of iCrowd LLC. The firm, which services brokers involved in direct investments into private companies, recently conducted a survey of that marketplace.

Of more than 900 accredited investors questioned, one in five of those aged 45 to 60 indicated they were directly involved in some sort of private-equity deal. Nearly half of all those high-net-worth investors aged 30 or under said they were involved in an outside business ownership stake.

"We knew people were interested, but that level of involvement really surprised us," Mr. McGee says.

The risks of taking a direct stake are much higher than some alternatives, such as investing in fund focused on private equity, Mr. Bird notes. A fund's manager is in a position to conduct due diligence full-time, and to create a diversified mix of holdings.

Experienced managers often try to structure deals with less onerous lock-up periods, making it easier for investors to take profits soon after a deal is complete. "Managers with clout and good connections get offered the best deals, which means that they are in the best positions to negotiate more attractive terms," Mr. Bird says.

Despite the potential pitfalls, he believes that private companies and properties are a largely overlooked type of asset. As a result, his firm has been pooling money of its well-heeled investors to selectively move into private-equity funds. "It's a huge part of the market that can provide more diversification to a portfolio over time," Mr. Bird says.

Mr. Stratton takes a similar view, but he is considering using an exchange-traded fund-- the $446 million PowerShares Global Listed Private Equity Portfolio. It follows an index of companies that lend capital or invest in private businesses.

It charges an expense ratio of 2.19%, a fee level that Mr. Stratton says is relatively high for an ETF but low compared to fees assessed by most private-equity funds.

The ETF is also dominated by financial sector names and smaller-cap stocks, which he suggests can make it a volatile holding.

"This is a fund that really underperformed during the financial crisis in 2007 and 2008, but in the past 12 months has been outperforming the broader market," Mr. Stratton says.

Another option is to devote a sliver of a portfolio to stocks of large private-equity players such as Fortress Investment Group and Blackstone Group. Owning these stocks can provide exposure to a wide variety of deals "without being subjected to paying the higher entrance fees," says Bryan Stephens, an adviser at UBS Financial Services in New York with $250 million in assets.

"It's the next-best option to participating directly in private-equity without locking up your capital for any significant period of time or paying higher fees," he says.

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