

LPs: We're ready for a downturn

Private equity investors look to distressed debt, VC and smaller buyout funds in anticipation of a recession

As economists debate whether the United States will succumb to a recession, institutional investors have begun anticipating a downturn.

Many LPs insist that they've been preparing for a recession for at least the last 12 to 18 months, turning slowly but surely to more distressed managers, middle-market and small-market firms, and venture capital.

"No one is rushing out and saying, 'sell my portfolio,' or 'radically change my allocation,'" says **Erik Hirsch**, chief investment officer at [Hamilton Lane](#), which manages about \$10 billion in assets. "These portfolios are big cruise ships that don't turn on a dime, and you wouldn't want them to."

In addition, LP expectations have been hard to dampen given the great returns that buyout funds have delivered. A recent survey of 785 colleges and universities that oversee \$411 billion in endowment assets found that they enjoyed a one-year average rate of return of 19.8% on their buyout investments in 2007, up from 17.9% in 2006.

The survey was sponsored by **National Association of College and University Business Officers** and [TIAA-CREF](#). Another recent LP survey, by London-based secondary buyer [Coller Capital](#), found that more than 40% of the 102 LPs surveyed said they expected net returns of 16% or more on their North American buyout investments over the next three to five years, and 96% said they planned to increase their private equity commitments.

Investors appear to have valued experience more highly over the last several months as economic conditions have worsened. "In all the underwriting we've done for the last 18 months, we've been thinking about whether a manager has invested through a [down] cycle, and what kind and how deep," says **James Kester**, head of private equity

for 2-year-old, New York-based **Zurich Alternative Asset Management**, which has been committing around \$300 million a year to buyout managers both indirectly and as a co-investor.

New and emerging managers also fall victim to bear markets because shrinking assets under management cause allocations to private equity to shrink. "Given restricted allocations, I think investors will be forced to focus on re-ups," says **Mac Hofeditz**, a managing partner at the San Francisco-based placement agency [Probitas Partners](#).

"It's getting more difficult to get a new name into a portfolio," says **Paul Denning**, CEO of San Francisco placement agency **Denning & Co**. "You're seeing that some of these LPs no longer have the capacity to absorb a new fund."

No worries for TRS

Among the LPs that appear unconcerned by what the market is doing is the **Illinois Teachers' Retirement System**, which has roughly \$42 billion in assets and reevaluates its asset allocation every three to five years.

"TRS structures its investment portfolio to weather up and down markets through the diversification of its portfolio [among] seven asset classes, and none of them really moves in tandem with the market," aside from public equity investments, says **Eva Goltermann**, a TRS spokeswoman who pointed to real estate, bonds and private equity as examples.

During the LP's most recent reevaluation, in December 2006, the state pension fund reduced its target allocation to U.S. equities from 40% to 30.5%, a move that took effect in July 2007, almost six months before the U.S. stock market plunged amid growing fears of recession. The LP said it was considering the long-term when it scaled back its U.S. equity program.

"We're not trying to time the market because that's what can get you in trouble," Goltermann says.

Opportunity in distressed

To take advantage of a downturn, **New Jersey's Division of Investment** and financial services giant [TIAA-CREF](#) have been boosting their commitments to distressed debt funds.

New Jersey has committed to a bevy of distressed funds in the past 18 months, including Avenue Special Situations Fund V LP, KPS Special Situations Fund III LP, MatlinPatterson Global Opportunities Fund III LP, WLR Recovery Fund IV LP and Wayzata Opportunities Fund II LP. The \$82 billion state pension fund expects to finalize its investment plan by May.

New Jersey's public pension program may up its allocation to those players when it finalizes its investment plan for fiscal year 2009, which begins in July, says Director **William Clark**.

TIAA-CREF has also hiked its commitment pace to distressed funds, according to **Sheryl Schwartz**, managing director of alternative assets. Last year, roughly 30% of its alternative investment commitments went to distressed investment managers, compared with between 10% and 15% in an average year.

A slump in U.S. public equities "will create a lot of opportunities for funds we've invested in," Schwartz says.

TIAA-CREF has more than \$437 billion in assets, with \$10 billion committed to the alternative asset class. It commits roughly \$1.5 billion to \$2 billion to private equity funds each year. —*Constance Loizos and Joshua Payne*