



September 2008

Private Equity and Real Assets

In our most recent Alternative Investment Report released in August, we commented on the credit crunch, commodity price inflation, and the massive de-levering of Wall Street. Given recent developments, particularly the Federal Government takeover of Fannie Mae and Freddie Mac, the bankruptcy of Lehman Brothers, and the bailout of AIG, we felt it necessary to provide further commentary and outlook.

Hammond Associates has been forecasting a deterioration of lending markets for more than 24 months as the excessive (and in hindsight, reckless) amounts of debt provided by the credit markets was simply not sustainable. The situation has worsened faster and more severely than we had anticipated. Despite the Fed's attempts to calm markets, there remains a lot of uncertainty and we can expect both difficulty and opportunity.

If there is one message we would like to reiterate to clients with regard to their private markets portfolios, it would be to remain disciplined and remember that private market strategies are implemented over multiple years in a programmatic approach that resists market timing (overly boosting or cutting new commitments). Commitments are budgeted over multi-year periods for vintage year diversification and portfolios are implemented based on strategic allocations designed to diversify strategy, sector, geography and manager risks.

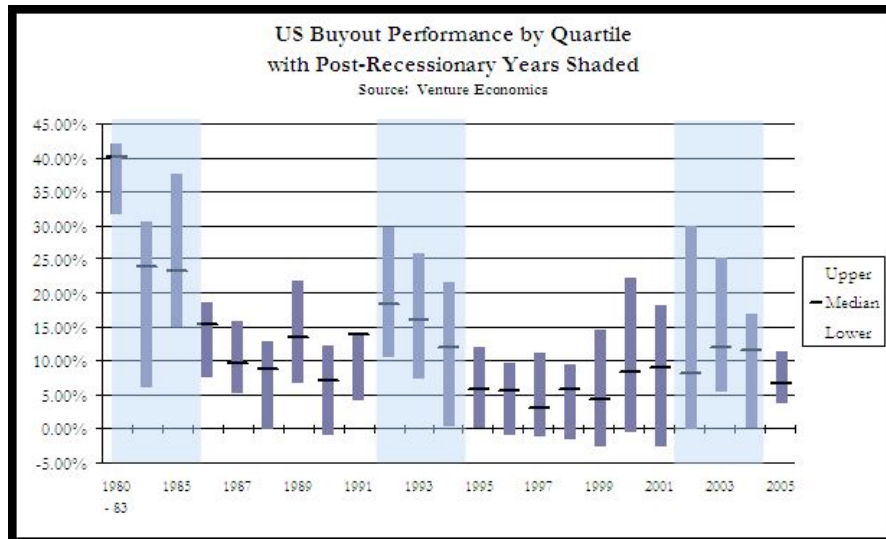
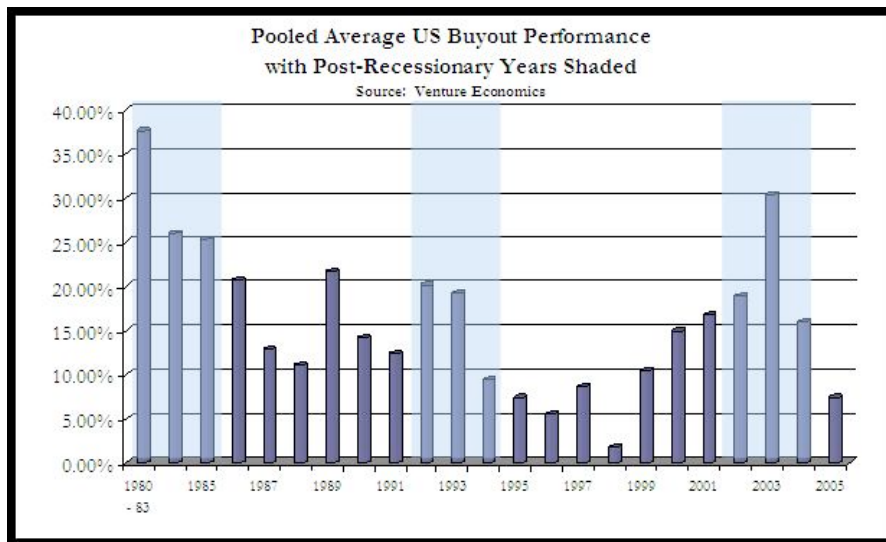
Private Equity

In general, the private equity markets have seen a dramatic decrease in activity since the beginning of the subprime meltdown last summer. Lenders have pulled back and the availability of debt financing has progressively decreased. The impact has been felt most severely in the mega-buyout space where deal financing had been supported by loose lending standards (covenant-lite and PIK Toggle) and a robust CLO market. Smaller buyout deals which never had access to these lending markets have continued to be transacted, but are certainly being affected by general lender and economic malaise. Portfolio companies that have been overleveraged or have near-term debt maturities are likely to be adversely impacted as a result of current market conditions. Even good companies will be challenged to meet expectations in the face of the credit crunch. There will inevitably be some failures and losses.

Our philosophy has consistently favored small and mid-market buyout strategies because such private equity portfolios are more conservatively capitalized and able to generate attractive relative returns from operational improvement strategies. Additionally, we have been advising clients to overweight allocations to special situations, particularly distressed strategies, for the last 24 months in anticipation of a market correction. Although we expected a correction, we certainly did not foresee the speed and severity of events we have witnessed. Investors who have committed capital to distressed strategies should be well positioned to capitalize on market turmoil as distressed sellers seek to generate cash. These strategies typically do not use acquisition leverage, so their ability to complete transactions is not as impacted by lending markets. We are not seeing widespread defaults, but turmoil in the banking system and the economic slowdown are setting the stage for a meaningful increase in distressed opportunities. Investors who have not allocated to special situations should consider doing so.

Looking ahead, we expect to top-off special situations allocations and turn our attention back to buyout strategies. You may wonder why we would allocate capital to strategies that require leverage when debt markets are closed. The reason is that recession-era buyouts have consistently been strong performers [see charts below]. While it may be difficult to complete a transaction right now, we are placing capital with the view toward having it deployed over the next few years. We would expect that trading-oriented distressed strategies will provide attractive near-term results while buyouts and control-oriented distressed strategies should generate attractive longer-term returns once the economy improves, portfolio companies' cash flows grow, and valuation multiples increase.

Hammond Associates research is grounded in fundamental beliefs about valuation, cycles, and mean reversion. We believe the tilts we have put into client portfolios will help them weather the current market volatility and give clients the confidence to pursue the market opportunities presented by such an interesting time.



Real Assets

We characterize real assets as an inflation protection vehicle within diversified portfolios. Those real asset strategies that employ leverage, such as real estate, will face challenges in the current market; however, the role of real assets as a provider of inflation protection is likely to be an important one. As the Fed and central banks globally inject liquidity into markets, we can expect the dollar to weaken, interest rates to decline, and inflationary pressures to grow. As such, real assets should provide a ballast for portfolio spending power.

Real Estate

In our last Alternative Investment Report, we commented that the real estate market is undergoing an adjustment process and that the hardest hit Core areas are likely to be in discretionary retail and suburban office properties, though for-sale residential and resort investments within Value Added and Opportunistic funds appear particularly vulnerable. We said that even though we have not experienced the same type of over-build we saw in the mid-late 1990s, we should see softness in more economically sensitive property types and weaker regional markets where there are fewer "credit" tenants and higher unemployment.

Well, now we are seeing an accelerated weakening of fundamentals as the credit crunch and a slowing economy are leading to decreased and even flat rent growth. Highly leveraged assets that were aggressively acquired based on rent growth prospects are likely to be challenged. Core funds that are income oriented (vs. appreciation) and subject to quarterly appraisals are showing the first signs of price correction as capitalization rates (income yield to total value) expand to normalized levels. Consequently, we are beginning to hear projections for NCREIF to be down 8-12% for 2008.

Again, anticipating a market correction, we advised clients to avoid making new investments in Core strategies. Low interest rates and significant investor capital in-flows propelled Core property valuations thereby compressing capitalization rates to their lowest levels in years. It was another scenario that was simply unsustainable. Instead, we advised clients to pursue Value Added and Opportunistic strategies where returns are driven more by asset appreciation from physical and operational improvements. Value Added and Opportunistic strategies are not immune to current market developments, particularly if they are highly leveraged or have short-term refinancing needs. However, these managers' existing investments should have a reasonable chance of achieving targeted returns through occupancy growth, facilities improvement, and development projects. Our Value Added and Opportunistic funds are also well positioned to acquire assets from distressed sellers. Although debt financing is harder to access for transactions, we have seen recent activity at leverage levels under 65% loan to value. That is probably the highest debt percentage that will be available until the lending markets normalize. If the debt markets pull back further and equity investments become less attractive, these managers are able and likely to adjust their tactics and acquire debt positions at steep discounts, thereby generating high yields. Remember that most Value Added and Opportunistic strategies were born out of the Resolution Trust Company era which is not too dissimilar to the current environment.

Energy

While energy is our best performing sector so far for 2008, it would have posted even better numbers if our funds were all unhedged. The run-up in oil and natural gas prices created meaningful unrealized declines in a couple of production-oriented funds as a result of their hedging strategies. Recent events have fueled concerns about a broad economic slow down that would lead to reduced overall production and therefore reduced demand for energy, particularly oil. However, if the dollar weakens as a result of stimulus actions on the part of the

Fed, we would expect oil and gas prices to remain high, if not climb. Our more exploration-oriented energy private equity funds have raised large, multi-billion dollar funds and made big commitments to portfolio companies that have been relatively slow to draw capital. While we have committed substantial capital to such funds, we have less capital at work than we would like. As such, we are getting a positive but modest impact from the allocations. Still, we believe these portfolios are well positioned to deliver attractive returns and provide a natural hedge against inflation.

Conclusion

The private market portfolios we have advised clients to adopt are strategic in nature with designs that are consistent with the long-term, illiquid nature of the asset classes. We also anticipated a market correction in light of market excesses over the last several years and have tactically (to the extent reasonable) positioned portfolios to best withstand and capitalize on distressed situations. We have planned customized multi-year commitment budgets for clients to provide vintage year diversification thereby effectively creating a dollar-cost-averaging. We did not advise doubling-down on our bets during market highs and we don't advise pulling out during market lows. Times like these remind us of the reasons why we have investment policies and diversified asset allocations; and we believe that our research portfolio is well positioned to weather this storm and capitalize on opportunities that arise.