

SECOND QUARTER 2010

PRIVATE CAPITAL OVERVIEW

IS IT TRUE?

News headlines are written to grab your attention. No doubt, however, press reports from responsible news media often hit a nerve or highlight a common concern. Recent articles from the Wall Street Journal and New York Times have raised concerns about the capital overhang in the buyout market and the demise of the venture business model.¹ This quarter's focus topic, "Is It True?" seeks to unravel fact from hype. As many of our clients and their constituents frequently read these publications, we hope this parsing of data is helpful. FEG private equity professionals Nathan Werner and Jim Angelica have teamed up to address these issues. As always, we welcome your feedback or follow up questions.

While the equity markets took a serious hit in the second quarter (down 11%), performance data for private equity is only available through the first quarter. As highlighted in the table, the first quarter continued positive trends in buyouts and venture capital following healthy public market returns. Activity levels for both new investments and realizations increased markedly for the first half of this year as compared to a year ago. Looking forward, multiples on buyout deals moved up from lows of 2009, but remain reasonable. Venture as an asset class continues to contract, which is healthy and likely to set the stage for improved returns. Recent weak markets could cause a slow down in these activity levels.

Performance Summary

Through 3/31/2010	Quarter	1 Year	3 Year*	5 Year*	10 Year*	20 Year*
Venture Capital	2.6%	11.5%	0.5%	4.6%	-1.5%	17.8%
Buyouts	4.6%	19.4%	-0.5%	5.4%	4.0%	9.0%
Private Core Real Estate	0.8%	-9.6%	-4.3%	4.2%	7.1%	6.5%
Timber	-0.2%	-5.7%	6.6%	10.4%	7.1%	11.6%
S&P 500 Index	5.4%	49.7%	-4.2%	1.9%	-0.7%	8.6%

Through 6/30/2010	Quarter	1 Year	3 Year*	5 Year*	10 Year*	20 Year*
Private Core Real Estate	3.3%	-1.5%	-4.7%	3.8%	7.2%	6.6%
Timber	1.1%	-3.5%	6.1%	9.9%	7.1%	11.5%
S&P 500 Index	-11.4%	14.4%	-9.8%	-0.8%	-1.6%	7.7%

*Annualized

Sources: Thomson Financial Venture Economics and www.NCREIF.com



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INSIDE THIS ISSUE

Private Capital Overview 1

Focus Topic: Is It True? 3

Private Equity 12
Venture 12
Buyout 15
Special Situations 17

Private Debt 19

Private Real Estate 23

Natural Resources 27
Timber 27
Energy 28

Disclosures 30

Research Team 31

While we do not have comparable metrics on the distressed debt and mezzanine markets, we note these areas have generated the strongest returns (per our experience with specific funds) over the past 12 – 18 month period. These include double-digit returns from Public-Private Investment Program (PPIP) funds. The opportunity set in credit oriented investments remains strong, but more oriented to the lengthy process of restructuring companies. Mezzanine and other cash flowing investments also have strong prospects for double-digit returns, while benefitting from high yields. Cash flow in uncertain times can be compelling.

Broad based real estate returns turned positive in the quarter and continued to increase through June. Demand for core investments has been strong and driving up pricing, while less stable and/or leveraged investments continue to manage debt maturities and cash flows. That said, we appear to be trawling along the bottom for these investments. Banks are increasingly moving assets to a workout stage as their improved capital bases allow realization of losses.

Recent industry polls have highlighted continuing trends toward the increased use of alternative investments by large investors, primarily at the expense of public equities. JP Morgan Asset Management finds an expectation of an additional 3.2% of total assets targeted for private equity, real estate, infrastructure, and other real assets investments over the next 2 – 3 year period.² Investors highlight return potential, diversification, and inflation protection as key advantages of these sectors. Fees and liquidity are noted as the key detractors. We believe these expectations are reasonable and investors are seeking high returns and diversification due to uncertainty. Of the many uncertainties facing investors today, the most prominent remains the economy. Any growth projections must be treated with caution as the viability of our recovery is hampered by high unemployment, increases in long term entitlement spending, ongoing deficit spending, the potential effective tax increase, and the still unclear impact of recently passed financial reform legislation. In the last quarter, we were comforted by Byron Wien's "V" recovery message, but note his July commentary emphasizes uncertainty with the full spectrum of "hope" to "calamity" pressing on his thoughts.³ We were also struck by Farallon Capital's recent letter commenting that "...societal expectations for growth are attitudes that are quite resistant to the onslaught of facts."⁴ While keeping these negatives in mind, there remains an impressive array of smart minds with capital and proper incentives that will find opportunities created by this uncertain environment.

¹ New York Times, June 24, 2010, "On Wall Street, So Much Cash, So Little Time"; Wall Street Journal, June 29, 2010, "Majority of VCs in Survey Call Industry Broken"; and New York Times, October 7, 2006; "A Kink in Venture Capital's Gold Chain"

² JP Morgan Asset Management Market Pulse: Alternative Assets Survey, June, 2010.

³ Market Commentary, Byron Wien, Blackstone Advisory Services, "The Smartest Man Thinks We Are Writing History", July, 2010

⁴ Quarterly Letter, Farallon Capital Institutional Partners, August 3, 2010

FOCUS TOPIC: Is It True?

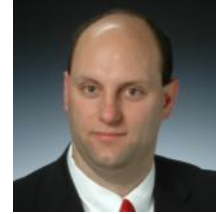
Pundits, mainstream media reporters, and industry practitioners have commented and criticized various aspects of private equity over the years. Recent concerns hitting the headlines include the excess amount of capital waiting to be invested with a ticking time clock to invest or lose that capital, volatile credit markets, overuse of leverage, venture capital performance below expectations, and industry contraction among venture firms reflecting a broken model for investing. This quarter's focus topic attempts to analyze these issues. We hope to (1) assess if these concerns discussed in the press about private equity are material; (2) determine if private equity investing remains compelling, and; (3) under what circumstances it should be included in a portfolio.

A review of industry data highlights that a high percentage of the capital overhang among buyout funds resides in the mega-sized funds (over \$5 billion), while the mid-market and smaller funds appear well balanced. In addition, while there is reason to view this data as overstating the actual capital outstanding, we also note that these mega-funds have several years to deploy capital before their investment periods expire, reasonably sufficient time assuming an average pace of investing. The data regarding the investment pace for the first half of 2010 paint an optimistic picture that includes lenders returning to the large end of the market. A recent study by Kaplan and Lerner concludes that venture capital performance largely mirrors that of the public markets over the last 10 years and that an industry contraction (less capital raised) will lead to better returns if historical relationships hold.¹

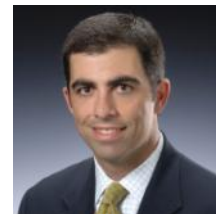
Whether hyped or maligned, the private equity industry continues to manage through cycles, although these cycles may outlast the tenure of the average investment committee member or chief investment officer. As such, clear policies, strategies, and communications are critical components to a successful private investing program. Without these stakes in the ground, media hype or criticism will likely negatively influence actions and outcomes.

Buyout

Private equity sponsors and the industry in general are certainly no strangers to unfavorable press. Two topics that received significant coverage, especially since the credit bubble burst in 2008, include (1) the capital overhang facing U.S. private equity managers and (2) the availability of debt to finance new transactions. The tone of the coverage ranges from valid concerns to hype. Depending on which articles are read one can understandably come away with some concerns.



Nathan C. Werner
Vice President



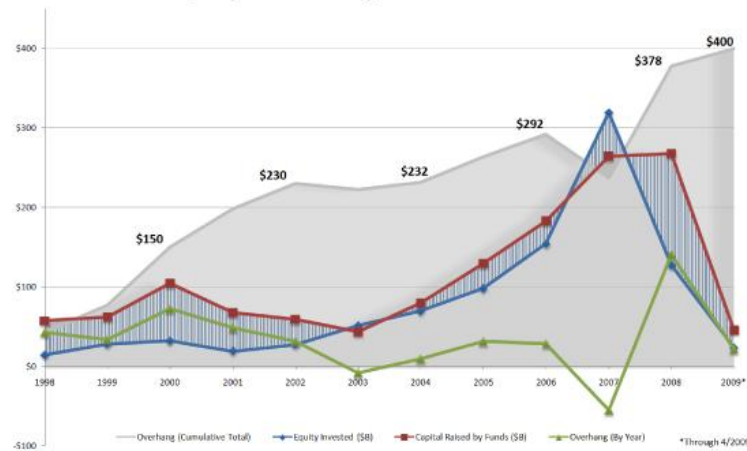
James W. Angelica
Senior Research Analyst

"...clear policies, strategies, and communications are critical components to a successful private investing program."

U.S. Private Capital Overhang

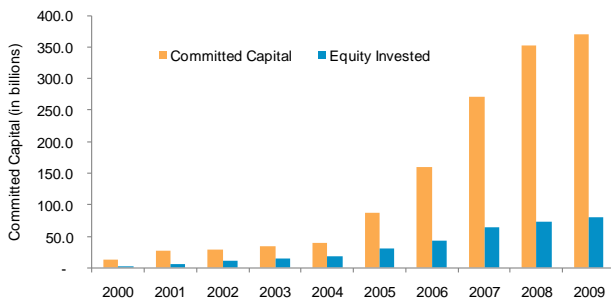
The U.S. private equity overhang is defined, in very simple terms, as committed capital less the equity invested over a given period. It has been estimated to be anywhere from \$330 billion to \$500 billion depending on the data source. The discussion regarding this situation began in earnest in the first half of 2009, following the largest yearly overhang for private equity on record. Many of the articles addressing this topic refer to the following data from PitchBook and the Alliance of Merger & Acquisitions Advisors (AM&AA). 2009 ended the year with a cumulative overhang of \$408 billion.

U.S. Private Equity Overhang

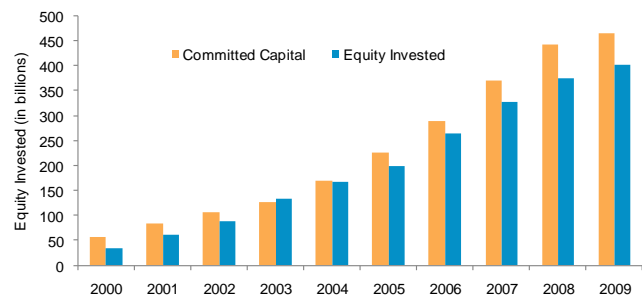


A closer examination of fundraising and investment data from ThomsonONE/Venture Economics indicates the overhang of capital disproportionately impacts the large end of the market. As shown in the following charts, from 2000 through 2009, limited partners contributed approximately \$835 billion across 1,257 U.S. private equity buyout funds.² More than \$360 billion was committed to 63 funds greater than \$5 billion in size, including \$282 billion from 2006 through 2009.³ The result, 44% of the capital was committed to 5% of the funds raised over this 10 year period. Equity invested, however, is a much different story. Approximately \$482 billion of equity was invested over this 10 year period, \$402 billion or 83% of which was by funds less than \$5 billion in size. As a result nearly 82% of the cumulative overhang is attributable to large funds.

Committed Capital vs. Equity Invested by Year
Funds Greater Than \$5 Billion



Funds Less Than \$5 Billion



Source: ThomsonONE/Venture Economics

The concerns raised by the media are that private equity managers are running up against a deadline to either put this capital to work, ask limited partners for an extension of the investment period, or return capital. There are concerns that “many firms are rushing to invest their cash as quickly as possible regardless of price”.⁴ Evidence shows equity invested slowed dramatically in 2008 and 2009, down 34% and 58%, respectively, compared to the peak in 2007, much to the approval of limited partners who were facing liquidity constraints. A few important considerations regarding the overhang data. Managers will typically hold in reserve a portion of the fund for follow-on investments that are made after the investment period of the fund ends. Also, there are funds that have not, and will not, call 100% of the committed capital over the life of the fund. As a result, there is committed capital imbedded in the overhang totals that will never be invested. A survey of industry terms indicates that 84% of all buyout funds and 100% of all buyout funds greater than \$1 billion have investment periods of five years or longer.⁵ If one applies this to the PitchBook data referred to earlier, the \$770 billion in capital raised during 2006-2009, more than three-quarters of which was raised from 2007-2009, has until 2011-2014 to be invested. The average pace of equity investment over the last 10 years has been \$93 billion per year. At that pace the current overhang would take four years to work through, or until 2014. Investment activity in the first half of 2010 was \$48 billion (an annual rate of \$96 billion), up from \$11.2 billion for the same timeframe in 2009, suggesting managers are beginning to work through the overhang.⁵ There is certainly a chance that some general partners will seek extensions to the investment period, however they will likely be the exceptions rather than the norm. The overhang of private equity capital is therefore not as big of a concern as some in the media have made it out to be due to the length of time left in the investment periods and the upward trend in the investment pace starting in the second half of 2009.

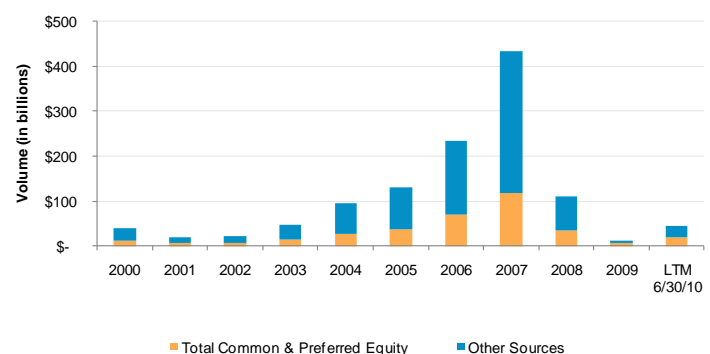
Availability of Debt

The second topic of recent concern relates to the availability of debt for the buyout market. The collapse of the credit markets in 2007 and the global economic slowdown that followed impacted all facets of the buyout market. Commitments, investment pace, and average deal size all declined as the financial equivalent of the “perfect storm” left investors managing ongoing liquidity concerns. When the government intervened in 2008, the primary objective of these bailout programs was to help banks lend money to businesses and consumers in order to “thaw” the frozen credit markets and re-start the flow of capital. Impaired by the most significant financial crisis since the Great Depression, and dealing with many of their own internal issues, banks that accepted these funds failed to increase their lending practices, resulting in the credit markets remaining frozen. Stung by the criticism they received, and buoyed by the strong performance of the public equity markets beginning in 2009, these banks are once again looking to lend.

Late in the third quarter of 2009, commercial and investment banks started to release their strangle-hold on debt and began financing deals at the large/mega end of the market. Even though these banks have come back to the market, they do not want to be exposed to syndication risk. As a result, the private equity sponsor is responsible for building a syndicate. Several of the large firms have formed capital markets groups in-house that have taken on this task and more are building out their capabilities.

Leveraged buyout volume in the U.S., as measured by S&P, dropped to \$12.7 billion from \$110.8 billion in 2008 and 97% from its high of \$433.7 billion in 2007.⁷ While well behind peak levels, the last 12 months through June 30, 2010 show a 71% increase over 2009 and many investors expect this trend to continue.

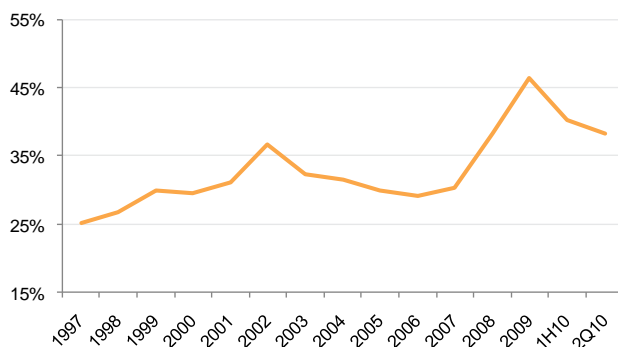
**Total U.S. Leveraged Buyout Volume
2000-2009**



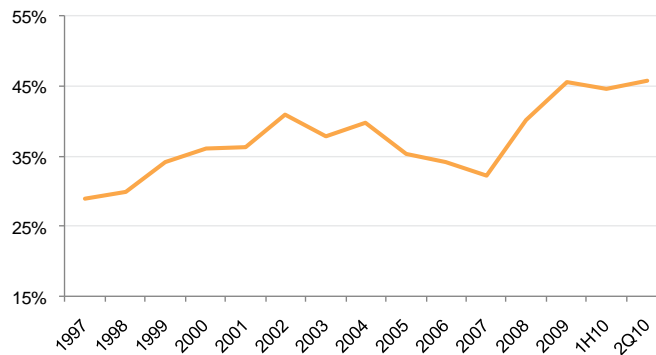
Source: S&P Q2 2010 Leveraged Loan Report

Buyout managers engaged in large transactions experienced a 6% decline in the amount of equity they need to invest to close a deal over the last year. Another data point confirming the increased availability of debt.⁸ Middle-market managers have not seen the same decline in equity contributions as their larger brethren, as these banks are focusing on large deals that they deem to be less risky.

**Equity Contributed by Sponsor
Large Corporate LBO Deals**



Middle Market LBO Deals



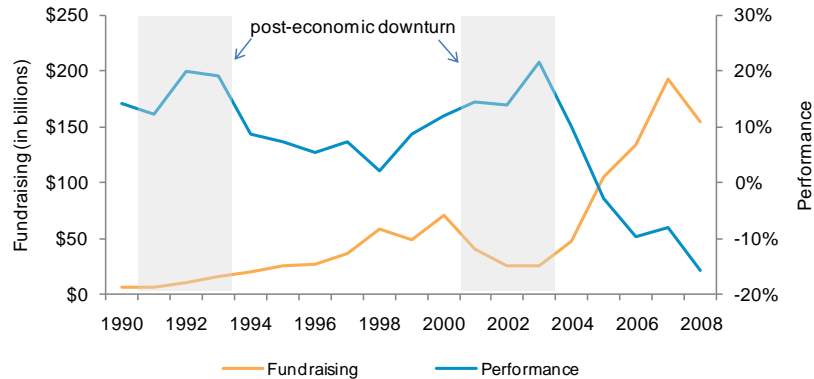
Source: S&P Q2 2010 Leveraged Buyout Review

Middle-market private equity managers have a number of different deal sourcing options as opposed to only auctions, typically seen in the large market. This gives them more flexibility, and in some cases, more negotiating leverage as these processes are often less competitive. Regardless, in most cases these deals will price significantly below larger auctions based on EBITDA multiples. Also, banks have not returned to this market with the same intensity; which leaves managers with two options, (1) invest more equity in deals, or (2) find an alternative source of financing to bridge the gap between the senior debt and the amount of equity they are willing to invest. These managers have become creative using mezzanine debt, sale lease-backs, asset based loans, etc. The small end of the market has been the least affected by the credit crunch. These funds will often invest growth equity with little to no leverage.

Looking Forward

In conclusion, a large capital overhang exists in the buyout industry, although it has been overstated. There are managers who have not called 100% of committed capital that adds permanently to the overhang, as they will never be able to close the gap between committed and invested capital. Managers will also typically reserve a portion of the fund for follow-on investments. Concerns over managers running out of time are also overstated. As the data show, this is not a systemic event in the buyout industry, but rather, an issue for the larger end of the market as, approximately 82% of the overhang is attributable to funds that raised over \$5 billion. Additionally, managers have several years remaining on their investment periods in which to deploy capital. If the investment pace in the first half of 2010, which is in-line with the 10-year average, continues, then the capital overhang would take approximately four years to work through. Furthermore, lenders are returning to the large end of the market, although very much on a deal-by-deal basis. The availability of credit should provide the capital necessary to complete larger transactions. John Arney, a managing partner at Candover said in a press release, “While it is difficult to predict the outlook for 2010, anecdotal evidence indicates that many PE firms are busy working on new investment opportunities and intuitively we should begin to see a stream of attractive post-recession buyouts emerging during the year.”⁹ The momentum appears to be shifting and Mr. Arney’s expectations for 2010 are beginning to materialize. Historically, performance of buyout funds have peaked during periods of low or declining fundraising and have shown their strongest performance over the three vintage years following economic downturns. The current environment presents an opportune time for investors to allocate a portion of their overall portfolios to buyout managers that are cycle tested.

Buyout Fundraising vs. Performance



Source: ThomsonONE/Venture Economics

Venture Capital

A survey of venture capitalists and an academic study two professors released this year reached opposing conclusions about the “brokenness” of the venture model. The truth likely resides somewhere in between. Venture capitalists frequently mention statistics such as fundraising, investment, and exit data over the last 10 years that caused the model to break. These statistics (fundraising, investment and exit data) might create the proverbial headwind or tailwind to the venture capital industry, but successful venture capitalists are constantly changing their models to adjust to the opportunity set and the market conditions. The academic study found that fundraising and investment activity remained consistent when considering the size of the total market and that the weak performance reflected poor public equity returns. Further, the current fundraising environment should lead to higher average returns if historical correlations hold. The following is an examination of the opposing view points and why FEG believes that now is a good time to invest in venture capital.

The Broken Model

The survey, highlighted in the Wall Street Journal, among other publications, discovered that 53% of venture capitalists described the venture capital industry as broken.¹⁰ Although the high level of negative sentiment about the industry might be noteworthy, it is hardly the first time participants have raised concerns about a “broken” model. In 2006, Steve Dow of Sevin Rosen caused quite a ruckus when the firm suspended fundraising and he announced that the “traditional venture capital model appears broken”.¹¹ Dow was hardly the first venture capital to express concern about the industry. For example, Paul Ferri of Matrix Partners warned in 2004 that venture capital was not a good asset class in which to invest at the time.¹² What did Ferri and Dow see coming that the majority of their peers more recently reached a similar conclusion and are they right?

Ferri mentioned two related factors as the primary causes for concern. First, the influx of new venture capitalists that coincided with the technology bubble and the capital they brought with them. This resulted in more companies chasing the same market, commonly referred to as “me-too” companies. Customers for technology products from venture-backed companies have more choices and it’s increasingly competitive to distinguish any one particular product. As a result, the amount and number of companies started in a specific market increased while the number of successful investments was limited. Dow also mentioned the flood of capital and plethora of companies, but went on

to describe the exit market as “terribly weak”. Essentially, there was too much capital going into venture capital with a bottleneck on the exit side that created an unfavorable industry environment.

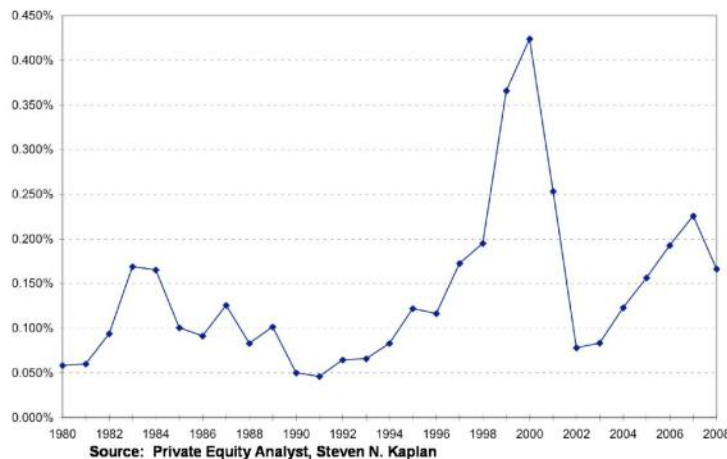
More recently, the exit markets, particularly the initial public offering (IPO) market, showed signs of life in 2007. The credit crunch of 2008 shuttered any progress, however, and venture capital-backed companies experienced the worst IPO market in 30 years in 2008 and 2009 with a total of 18 IPOs during those two years combined. At the same time, commitments to venture funds slowed dramatically over the last two years as investors grew concerned about liquidity and found themselves over-allocated to the asset class amid falling portfolio values from the public market, also known as the denominator effect. The contraction in the industry is underway as firms cease to raise new funds. For example, last year Frazier Technology Ventures shut its doors after failing to raise a fund and we expect other firms may follow suit as the fundraising environment has not improved in 2010.¹³

It Ain't Broke

To recap, venture capitalists cite too much capital, too many new entrants, too many companies funded, and not enough exits to generate returns. Two well-known professors, Steven Kaplan and Josh Lerner, recently published their findings on the validity of the concerns mentioned above by industry practitioners. Looking at the venture capital data from a historical perspective and comparing to the broader public market, Kaplan and Lerner concluded that the venture model was not broken. Following are some of the key findings of their study:¹⁴

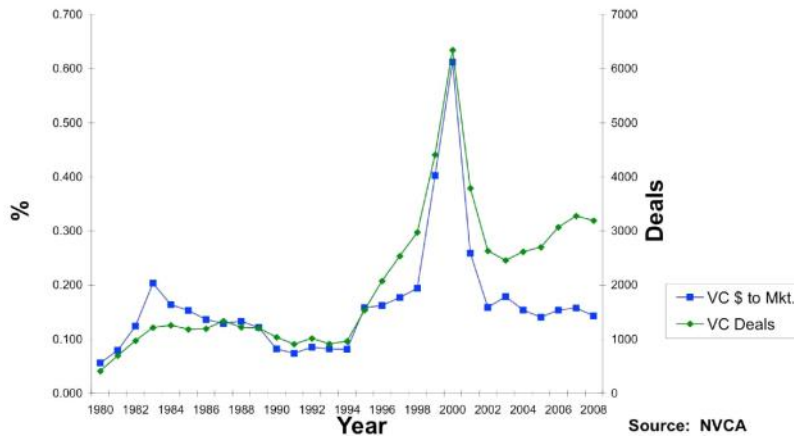
1. Commitments as a percentage of the total stock market have been relatively stable, between 0.05% and 0.23%, with the exception of the bubble years of 1999-2001. The average annual commitment percentage since 2002 (roughly the era of the “broken model”) of 0.146% is slightly higher than the average since 1980 of 0.138%.

Commitments to U.S. VC Partnerships
as fraction of stock market capitalization 1980 - 2008



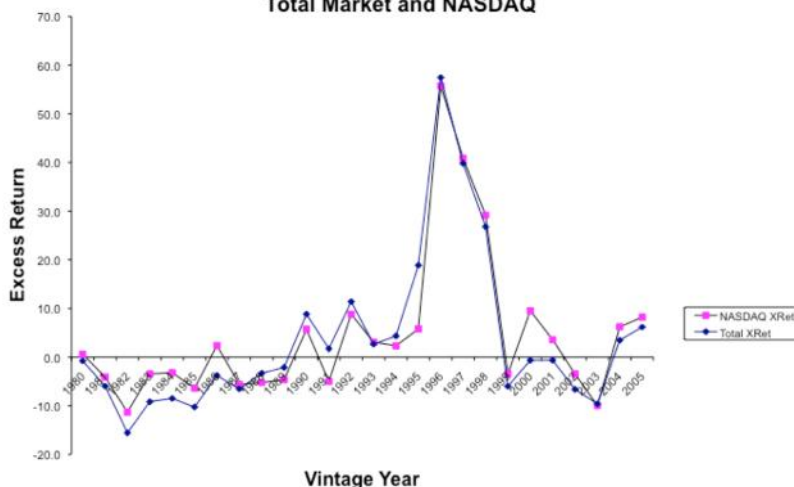
2. Similarly, venture capital investments as a percentage of the total stock market varied little over the same time period. The long-term average was 0.164% since 1980 and there were only three years (1999-2001) where investments exceeded 0.203%. Since 2002, the average annual investment percentage of 0.155% was below the long-term average.

U.S. VC Deals and \$ Invested (as % of Mkt.)



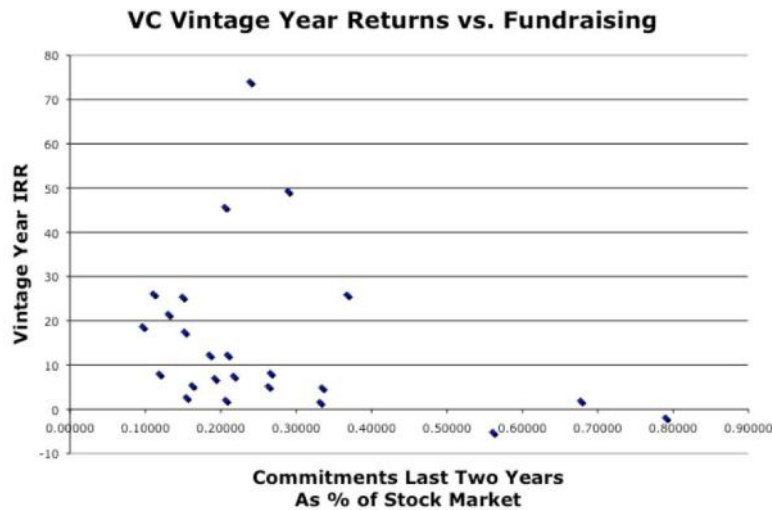
3. With respect to venture capital returns, venture capital performance predominantly mirrors that of the public equity market. For example, of the six vintage years from 2000-2005, venture funds performed worse than the public equity market for two of the vintage years, better than the public equity market for two of the vintage years, and the same as the public market for two of the vintage years.

Excess Vintage Year Return versus Total Market and NASDAQ



4. Kaplan and Lerner found a negative correlation exists between venture capital returns and the preceding years' capital commitments as a percentage of the total stock market. In other words, the higher level of capital commitments, the lower the average return for that vintage year. Kaplan and Lerner describe this as a self-correcting mechanism (similar to the circular diagram in last quarter's [FEG Private Capital Review](#)). A period of poor returns leads to decreased commitments and inflows, which leads to a recovery in returns. The recovery in returns leads to greater interest (more commitments and investments) and a period of poor returns. If this correlation holds and the current

trends continue, then venture capital is likely entering a period of vintage years that turn out quite positive due to the falling levels of commitments and investments. As shown below, when commitments to venture funds as a percent of the total stock market are low, then returns are generally higher, while larger commitments tend to lead to poor industry returns.

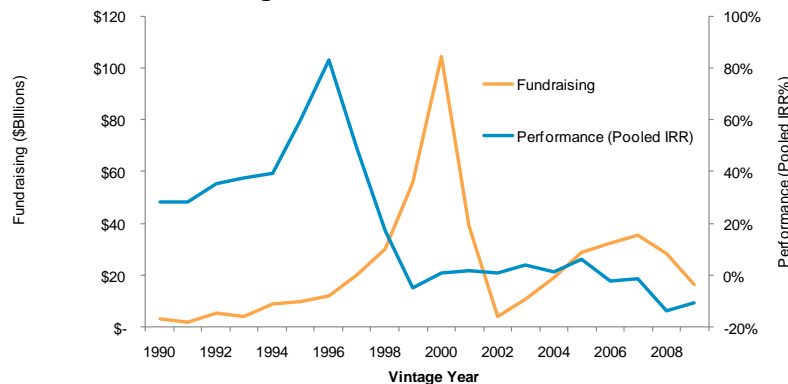


Source: Kaplan, Steve and Lerner, Josh, "It Ain't Broke: The Past, Present, and Future of Venture Capital"

Looking Forward

After experiencing a challenging decade, we should not be surprised at the pessimism found among venture capitalists about their industry. The technology bubble popped, the IPO window was (and is) difficult at best and closed at worst, and an increasing number of companies received venture funding. Some of the concerns raised by venture capitalists and mentioned in the mainstream media are material, but should be viewed in a broader context. Kaplan and Lerner argue that venture capital fundraising activity and investment level (by capital) in relation to the broader stock market remains consistent over time. Additionally, venture capital performance reflects the poor public equity market performance. Most importantly, the venture industry currently enters a period of reduced fundraising, which should lead to higher industry-wide performance if historical correlations hold.

Venture Fundraising vs. Performance



Source: Thomson One/Venture Economics

The venture capital model continuously evolves as the industry dynamics change and as the public equity markets perform. The model that worked in the late 1990s does not work today. The poor fundraising environment will likely cause some venture funds to close, but should provide the opportunity for those remaining to achieve premium performance to the public equity markets. The chart above also shows how the high returns in the 1990s, which peaked in 1996 preceded a spike in commitments in 2000, which preceded the lower returns over the last decade. The

drop in fundraising that began in 2008 continued through the first half of 2010 and is approaching the levels during the early 1990s. For investors with the willingness and ability to assume the illiquidity and investment risk, this is an advantageous time to commit to venture capital funds.

Conclusion

We are never as good as we might think on our best day and never as bad as we feel on our worst. The same can be said of what is written about private equity investing. Evidence of the presence and impact of a capital overhang has been overstated and the impact of leverage is a factor for the largest, most visible private funds, but certainly not all. FEG's research evaluates the impact of capital flows on broad market activity and, in fact, we find the current environment benefits from the negative press as it drives capital away and increases the prospect for long-term investors who commit a portion of the total portfolio to higher returning strategies. Private equity investing is not a fit for everyone. Private equity investing includes long holding periods, illiquidity, and risks to the investment strategy above and beyond those risks in the public markets. It frequently takes several years to generate positive returns. As such, private equity best fits those investors with an ability and willingness to tolerate its unique risks. The returns compared to the public markets justify including a private equity allocation in the portfolio implemented by using carefully researched investment opportunities and diversified across vintage years.

¹ Kaplan, Steve and Lerner, Josh, "It Ain't Broke: The Past, Present, and Future of Venture Capital"; Journal of Applied Corporate Finance, Volume 22 Number 2.

²⁻³ ThomsonONE/Venture Economics, www.thomsonone.com, "Commitments", August 4, 2010

⁴ New York Times, June 24, 2010, "On Wall Street, So Much Cash, So Little Time".

⁵ Dow Jones Terms and Conditions Report, 2010

⁶ ThomsonONE/Venture Economics, www.thomsonone.com, "investment Analysis" August 5, 2010

⁷ Standard & Poors, "Q2 2010 Leveraged Buyout Review", Total US Leverage Buyout Volume

⁸ Standard & Poors, "Q2 2010 Leveraged Buyout Review", Equity Contribution by Sponsor

⁹ www.dealbook.com, The New York Times: Deal Book, "Private Equity Deals Leveled Out Last Quarter", January 25, 2010

¹⁰ Wall Street Journal, June 29, 2010, "Majority of VCs in Survey Call Industry Broken".

¹¹ New York Times, October 7, 2006; "A Kink in Venture Capital's Gold Chain"

¹² Private Equity Analyst, March 1, 2004 "Worst Not Over For Venture Industry, Paul Ferri Says".

¹³ "5 Questions for Len Jordan, Frazier Technology Ventures" accessed on www.pehub.com on November 5, 2009

¹⁴ Kaplan, Steve and Lerner, Josh, "It Ain't Broke: The Past, Present, and Future of Venture Capital"; Journal of Applied Corporate Finance, Volume 22 Number 2.

PRIVATE EQUITY: VENTURE CAPITAL

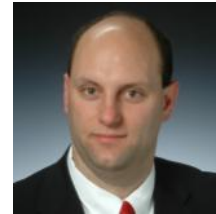
The first half of 2010 treated venture funds kindly, as exit activity increased and returns improved significantly compared to where the industry was a year ago. Fundraising activity continued to decline, which suggests that investors making commitments to venture funds today are in a better position to achieve expected returns as mentioned in a recent study in this quarter's focus topic.¹ Although venture fund performance over the last ten years fell short of expectations, it largely reflected that of the broader public equity market and appears to be heading in a positive direction. Market conditions can change quickly, as similar positive data occurred in 2007 before the implosion of the public equity markets in 2008 shuttered any progress and shut down the exit markets for the next two years.

Fundraising and Investing Environment

Venture funds continue to struggle to raise capital since the market turmoil began in late 2008 as investors remained reluctant to commit to the asset class. Venture capital fundraising in the second quarter of 2010 was the lowest quarterly level since the third quarter of 2003. Investors committed \$1.9 billion in the second quarter, 49% less than last quarter.² Commitments in the first half of 2010 totaled \$5.7 billion, a decline of 41% compared to the first half of 2009. Similarly, the number of funds raising capital continued to fall. Through the first half of 2010, 69 funds raised capital compared to 94 funds in the first half of 2009, a decline of 27%. From 2005-2007, an average of 62 funds raised capital every quarter compared to the average of 34 in 2010, a drop of 45%. By every metric and virtually every time period, the number of funds and capital raised continued to decline in 2010, evidence of a material contraction in the industry.

Investment activity rebounded in the second quarter, as venture firms invested \$6.5 billion into venture backed companies, a 34% increase over the \$4.9 billion invested during the first quarter of 2010.³ The \$11.4 billion invested in the first half of 2010 rose 49% over the \$7.7 billion invested in the first half of 2009, a particularly slow period on a historical basis. Despite the bounce back in the second quarter, investment activity in 2010 remained low on a historical basis. For example, venture funds invested an average \$7.0 billion per quarter from 2006-2008. If the current pace continues through the end of the year, then the amount invested in 2010 will be 19% lower than the 2006-2008 average. This was the first quarter since the third quarter of 2008 where funds invested more than \$6 billion.

With respect to sector investments, the biggest story of the quarter was clean technology investing. Venture funds invested \$1.5 billion in clean technology companies during the second quarter, more than double the amount in the first quarter and a record for that sector. The investment in clean technology companies was driven by large deals including seven of the largest ten deals in the quarter. Clean technology investment activity



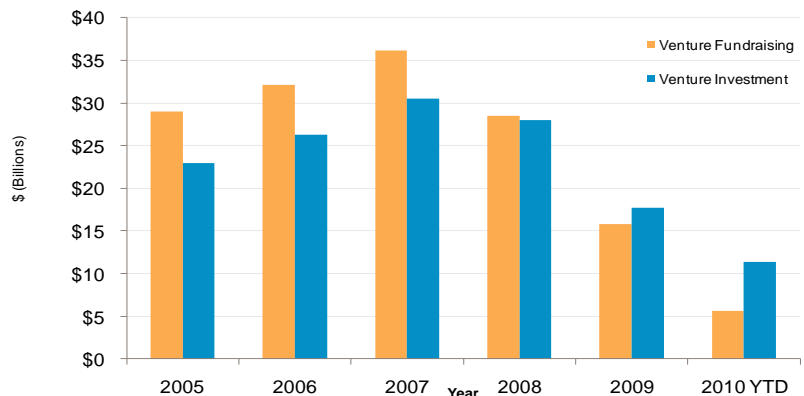
Nathan C. Werner
Vice President

“Fundraising activity continued to decline, which suggests that investors making commitments to venture funds today are in a better position to achieve strong performance.”

reflected the higher capital intensity of some of those companies, as well as the return expectations from some of the venture funds. Other notable sectors included biotechnology (\$1.3 billion) and software (\$1.0 billion). On a quarter-over-quarter basis, investments rose in every stage by over 40%, with the exception of late-stage investing, which declined 2%. Similarly, investment activity rose over 40% for every stage except for late-stage, which rose 13% compared to year-ago levels. A couple of quarters don't necessarily make a trend, particularly in venture capital, but this in late stage venture will be an area worth monitoring.

From 2005-2007, venture funds raised an aggregate \$17.5 billion more than was invested before being in equilibrium for the 2008 calendar year. This capital overhang began a reversal in 2009 and accelerated in the first half of 2010, as funds invested \$7.6 billion more than was raised since the start of 2009. The capital overhang in venture fell sharply due to the anemic fundraising environment. Despite the slight rebound in investment data, anecdotally, industry participants mention an increasing reluctance of some venture funds to deploy remaining capital in an uncertain fundraising environment. Over the long-term, the fundraising and investing data should be roughly equivalent.

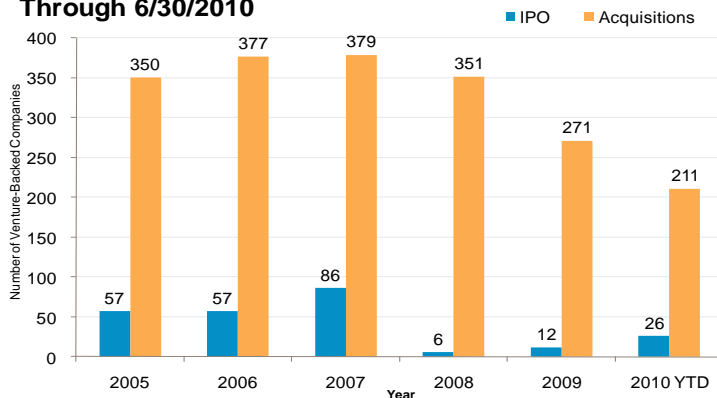
Venture Capital Investment & Fundraising Data through 6/30/2010



Source: National Venture Capital Association. Press Release dated July 12, 2010, and PWC Moneytree Report 2Q10.

Exit Environment

Venture Capital Exit Activity Through 6/30/2010

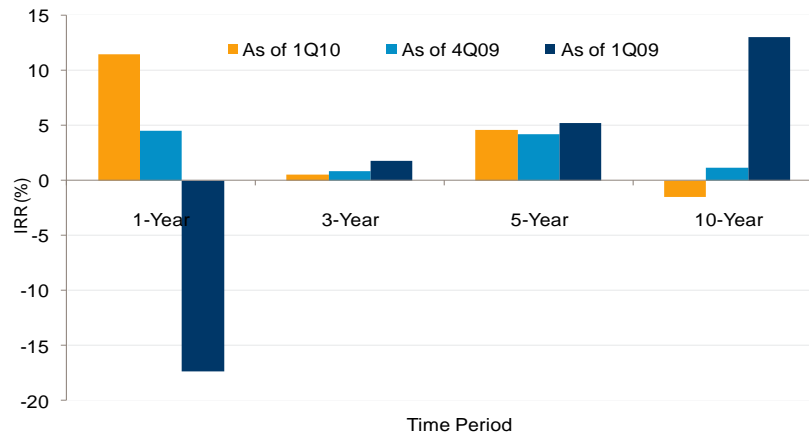


Source: National Venture Capital Association. Press Release dated July 1, 2010.

IPOs compared to a total of 18 in all of 2008 and 2009 combined. The number of IPOs in the second quarter almost doubled the nine that went public in the first quarter. Of the 17 companies that went public, only 5 were trading above their offering price as of quarter-end, reflecting the challenges of the public markets. The much-hyped Tesla Motors was also the biggest IPO of the quarter, as the company raised \$229 million. The number of venture-backed companies filed with the SEC to go public increased from 10 as of June 30, 2009, to 44 as of June 30, 2010, suggesting further IPO activity in the coming quarters.

Acquisitions of venture-backed companies continued on a record pace through the first half of 2010 and continued to dominate exit activity, although IPO activity improved as well. In the second quarter of 2010, 92 venture-backed companies were involved in merger and acquisition activity, following the record 119 transactions in the first quarter.⁴ The 211 companies in the first half of 2010 exceeded year-ago levels by 64% and 2010 will go down as the most active year on record if the pace continues through the end of the year. In 2009, a total of 271 companies were acquired during the year, which makes the first half's activity level almost 80% that of the preceding twelve months. The second quarter of 2010 saw 17 venture-backed

Venture Capital Performance -- Pooled IRR



Source: Venture Economics; Accessed via website on August 4, 2010.

Performance

Venture capital fund performance reports on a quarter-lag basis and short-term performance can be misleading given the long-term nature of the strategy. As shown in the chart above, performance for the twelve months ending March 31, 2010, improved significantly from last quarter's twelve-month performance and the one-year performance from March 31, 2009, due to an improved exit market. Three-year and five-year performance figures were relatively unchanged. The ten-year performance continued to decline as the effects from the technology bubble (high valuations and hot IPO environment) rolled off the time period.

¹ Kaplan, Steve and Lerner, Josh, "It Ain't Broke: The Past, Present, and Future of Venture Capital"; Journal of Applied Corporate Finance, Volume 22 Number 2

² NVCA Press Release "Venture Capital Fundraising Activity Remains Low"; July 12, 2010.

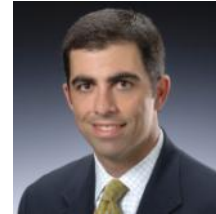
³ PriceWaterhouseCoopers MoneyTree report (Second Quarter 2010) accessed at www.pwcmoneytree.com on July 16, 2010.

⁴ NVCA Press Release "Venture-backed IPO volume continues to increase in Q2 2010 while acquisitions hold steady"; July 1, 2010.

PRIVATE EQUITY: BUYOUTS

While there are challenges facing the global buyout industry, the market seems to be in a better place today than it was 18, or even 12 months ago. One of the issues facing private equity has been addressed in the Focus Topic of this Research Review, the overhang of capital in the U.S. private equity market. The overhang of capital in the market is significant, however it is not systemic. The data show that the overhang disproportionately affects the large/mega end of the market and approximately 40% of the cumulative overhang is due to the imbalance of capital raised versus equity invested from 2007-2009. The good news is funds with these vintage years still have two to four years left on their investment periods to invest capital. Despite the overhang, the market has continued to see encouraging signs. New investment pace of managers continued on a positive trend, the rebound in the public equity markets had a positive impact on exits, and large commercial and investment banks have once again begun lending. Indications are that 2010 will be a better year for private equity than 2009 and significantly better than 2008.

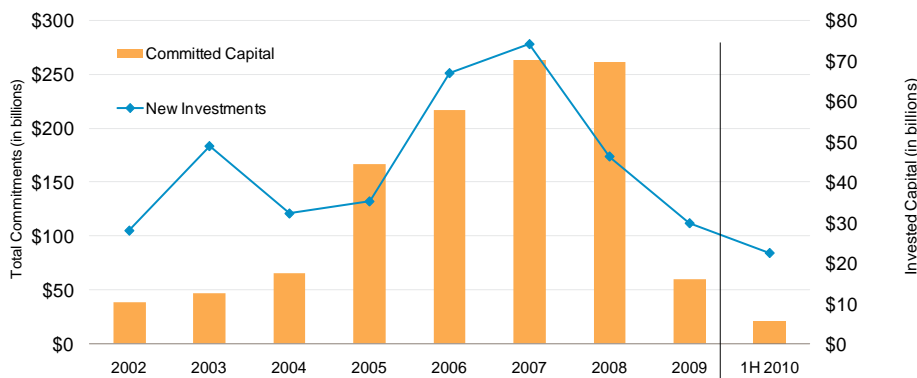
ThomsonONE/Venture Economics data for the second quarter of 2010 show a decrease in capital commitments to global buyout funds. Commitments declined by \$3 billion, or 25%, quarter-over-quarter, from \$12 billion in the first quarter 2010 to \$9 billion in the second. When compared to the same time frame last year, commitments declined by 45% from \$16.4 billion. This decline is similar comparing first half activity. Looking forward, an increase in commitment pace is anticipated for the second half of 2010. The pace of new investments seems to have stabilized from quarter to quarter with new investments totaling roughly \$11 billion in each of the first two quarters of this year.² The investment pace for the first half of 2010 increased by 163% over the same period in 2009, from \$8.5 billion to \$22.4 billion. Year-to-date invested capital was roughly equivalent to the amount of capital raised.



James W. Angelica
Senior Research Analyst

“The investment pace for the first half of 2010 increased by 163% over the same period in 2009... Year-to-date invested capital was roughly equivalent to the amount of capital raised.”

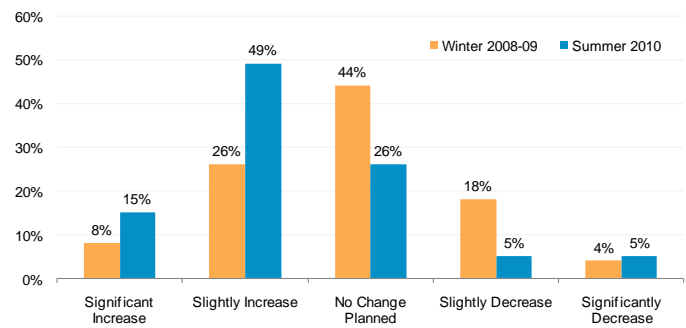
Global Buyout Commitments and New Investments



Sources: ThomsonONE/Venture Economics, August 6, 2010; includes LBOs and Acquisitions

There is good reason for general partners to be optimistic based on a recent survey conducted by Collier Capital. The survey concluded that limited partners still feel confident about the private equity asset class despite the rough patch the industry has been through. When asked if they plan to raise the portion of their portfolios dedicated to private equity, 64% responded yes, including 15% that said they plan to “Significantly Raise” their private equity allocation.³ Limited partners give up but they also take away. In the same survey 38% of respondents (mostly in the U.S.) plan to shrink the number of relationships they have with general partners over the next two years. In terms of geography, the limited partners that participated in this survey favor the Asia-Pacific Region, as well as emerging markets.

LPs Planned Pace of New Private Equity Pledges

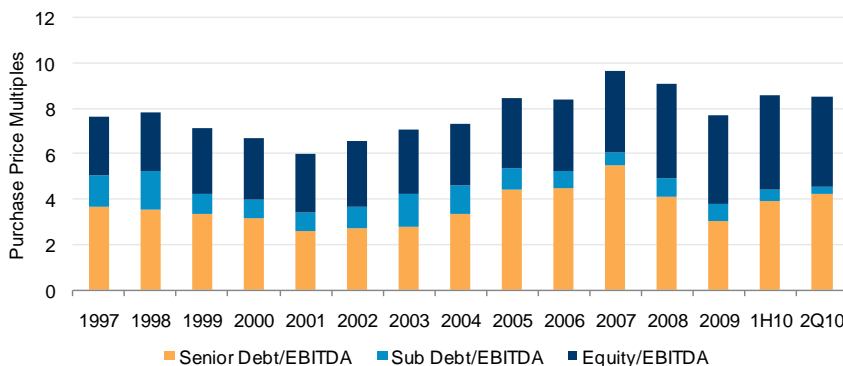


Source: Collier Capital

The exit markets for private equity investments improved significantly in percentage terms with the number of IPOs up from just 6 in all of 2008 to 20 in 2009 with 18 coming in the fourth quarter alone. The trend continued into the first half of 2010 with 13 additional IPOs, including 5 in the first quarter and 8 in the second.⁴ With regard to mergers & acquisitions, activity for 2010 increased significantly, as 65 deals were completed in the first half of 2010 compared to 64 deals for all of 2009.⁵ Industry participants expect exits to increase in the second half of 2010, especially among the smaller funds that may sell up the financial food chain to larger private equity investors.

Credit returned to the buyout market, although more discriminately than in the so called “Golden Age” of private equity. The chart below highlights average purchase price multiples for buyout deals, including detail on debt and equity. The average multiple for 2009 was 7.7x EBITDA (earnings before interest, taxes, depreciation and amortization), the lowest level since 2004 when the average was 7.3x. As the credit crisis took hold in 2008, the portion of the multiple attributable to senior debt decreased substantially, as the credit markets went into hibernation. Equity capital comprised the difference and remained at nearly half of the total purchase price throughout 2008 and 2009. In the first half of 2010, senior debt once again became a larger part of leveraged buyout transactions, especially among the larger funds. Please refer to our focus topic for more information regarding the return of credit to the buyout market.

Average Purchase Price Multiples as of June 30, 2010



Source: S&P Q2 2010 Leverage Buyout Review

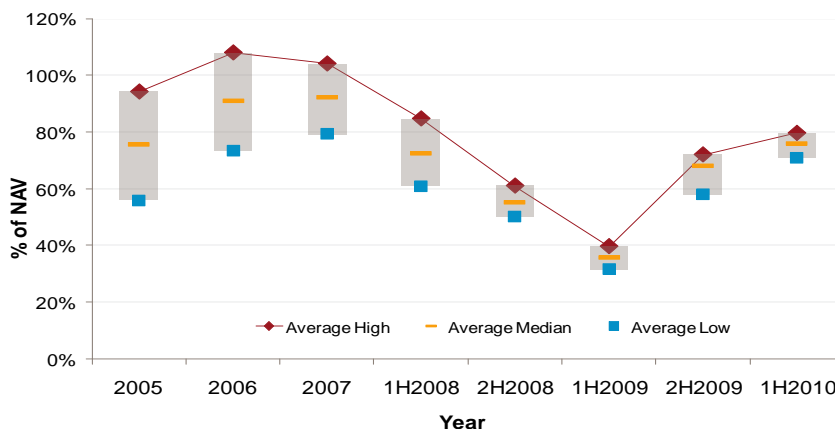
While there are still challenges facing the private equity industry, investors are advised to avoid the attempt to time the market, but instead remain sensitive to the valuation discipline of the fund manager. There is evidence that the best time to invest in buyouts is coming out of an economic downturn (see chart titled “Buyout Fundraising vs. Performance” in this quarter’s focus topic). Signs of credit flowing back into the market supporting the pace of new investment continued on a positive trend, and valuation measures, while not at trough levels, appear reasonable.

PRIVATE EQUITY: SPECIAL SITUATIONS

Private Equity Secondary

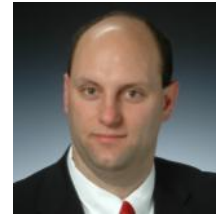
Pricing in the private equity secondary market rebounded in 2010, reflecting the improved exit markets and reduced distress from liquidity concerns and the denominator effect. Pricing based on NAV rose from an average high bid of 72.0% in the second half of 2009 to 79.6% in the first half of 2010.¹ The low prices seen in late 2008 and 2009 reflected a time of distress in the market, as sellers sought to generate liquidity from their illiquid holdings and to reduce their obligations to future capital calls. As mentioned in prior FEG's Private Capital Reviews, the funds sold on the secondary market during 2008 and 2009 included a large percentage (number or portion) of funds that were less than 50% called, what the industry participants call "seasoned primaries".² In addition, new entrants accounted for nearly 80% of the volume during this time, according to Cogent Partners, a broker for secondary transactions.

Secondary Bid Prices Over Time



Source: Cogent Partners Secondary Pricing Trends & Analysis, July 2010

To recap, the secondary market from 2008 through 2009 included new entrants to the space that bought largely unfunded positions at relatively low prices, while the more experienced dedicated secondary buyers largely sat on the sidelines. A multitude of factors played a role in this trend. Based on anecdotal feedback from industry participants, the secondary managers grew cautious and underwrote more conservatively. They found would-be sellers were unwilling to part with assets at bargain prices and the types of funds in their sweet spot were not being sold. Buyers expected sellers would capitulate under liquidity duress, but it rarely occurred. Rather than liquidating fully-funded holdings to generate cash, sellers focused on unloading future liabilities by shedding funds that were largely uncalled. Despite the virtually universal message about the buyers' deal pipeline never being more full, few transactions closed because of the divergent price expectations of the buyer and seller. Essentially, buyers overestimated the seller's distress level and grew more risk averse.



Nathan C. Werner
Vice President

"In the first half of 2010, higher pricing reflected a relative return to normalcy with buyers and sellers on more balanced footing."

In the first half of 2010, higher pricing reflected a relative return to normalcy with buyers and sellers on more balanced footing. Sellers grew more interested in liquidating older funds, the typical sweet spot for most secondary buyers, as the average fund sold by Cogent was 73.6% funded in the first half of 2010 versus 60.6% funded in the first half of 2009. Increased activity in the exit markets gave buyers more confidence valuing assets and the liquidity pressures eased leading to the price increase. Of particular interest in 2010, two large transactions occurred as financial institutions liquidated their private equity holdings. Collier Capital purchased 70% of the private equity holdings from Lloyds Banking Group's subsidiary, Bank of Scotland, for £332 million.³ In addition, Lexington Capital paid a reported \$900 million to Citigroup for a portfolio of private equity assets.⁴ The gridlock in secondary market activity clearly appears to be easing.

¹ Cogent Partners, Secondary Pricing Trends & Analysis, July 2010

² Cogent Partners, Secondary Pricing Analysis Interim Update, July 2009

³ Lloyds press released dated July 5, 2010, "Lloyds Banking Group Announces the Sale of Bank of Scotland Integrated Finance to a Joint Venture Majority Owned by Collier Capital"

⁴ Reuters, "Citi confirms sale of private equity unit", July 13, 2010.

PRIVATE DEBT

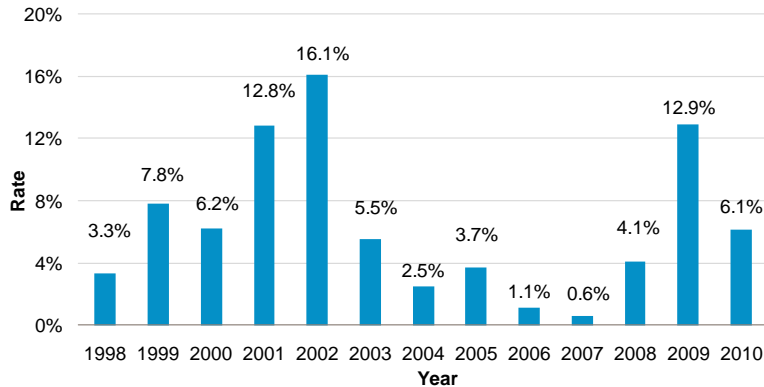
Credit Markets/Distressed

As highlighted in the chart below, defaults for speculative grade bond and bank loan issuers peaked in 2009 and trended lower throughout 2010 as the credit markets became active and the economy began its recovery. Distressed ratios (defined as issues trading at over 10 percentage points over Treasuries) for bonds and bank loans declined to pre-crisis levels. At present, conditions do not argue for meaningful new allocations to traditional distressed trading strategies, which are most attractive at entry prices much lower than what is available today. At this point in the credit cycle, distressed investors who made purchases during the downturn are in the workout or restructuring phase of their investments. As most bond and distressed investors tend to view the glass as half empty, the consensus opinion is for a lengthy workout period in this credit cycle. This view of the credit cycle is shared by FEG, although we couch our concerns for the credit markets primarily due to the bank loan and high yield maturity schedule, projected to peak from 2012-2014.



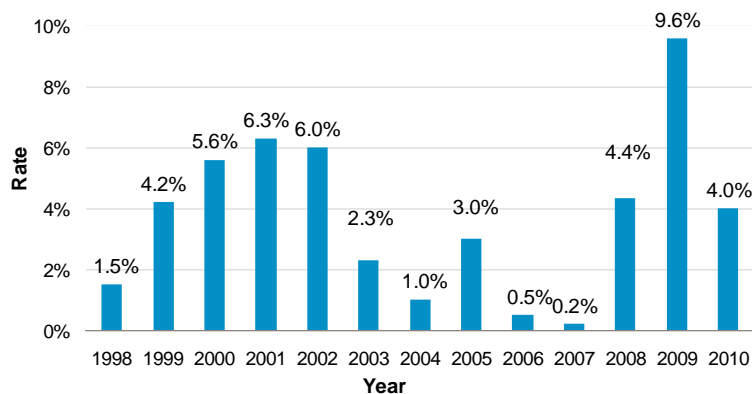
Keith M. Berlin
Vice President

Moody's Speculative Grade Defaults



Source: Moody's

Loan Index Defaults



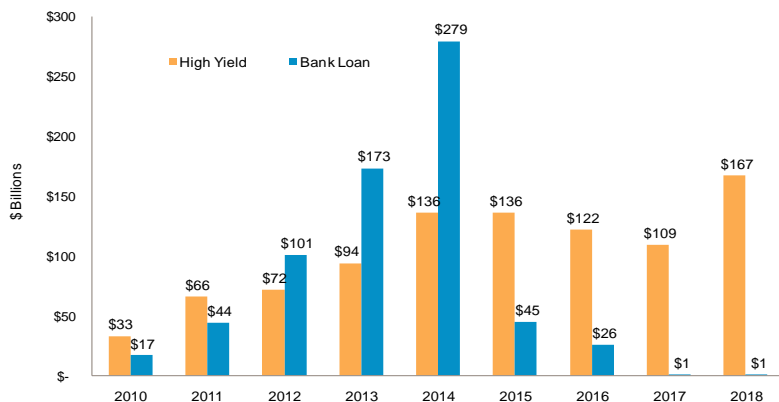
Source: Standard & Poor's LSTA

“What makes the 2012 to 2014 credit markets particularly worrisome is the end of the reinvestment period for collateralized loans.”

In the focus topic of our May 2010 Research Review, titled the [Merits of Credit Hedge Funds](#), we posited that following the broad recovery in risk assets, credit investors should begin focusing on what could potentially derail the high yield bond and bank loan markets over the next three to five years. The following charts explain our concerns about the future for the credit markets. The chart below is the debt maturity schedule for bank loans and high yield bonds as of June 30, 2010. As the chart depicts, from 2012 to 2014 will be \$550 billion in bank loans set to mature and in addition to \$300 billion in high yield bonds.

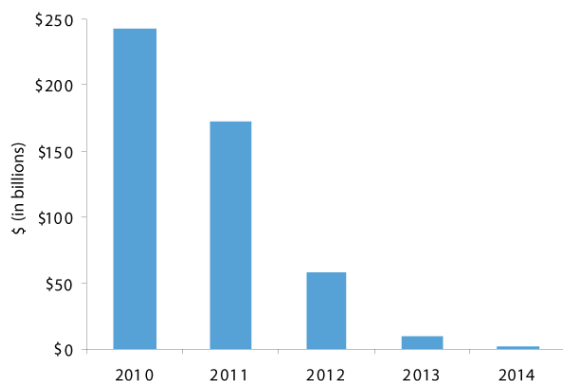
What makes the 2012 to 2014 credit markets particularly worrisome is the end of the reinvestment period for collateralized loan obligations (CLOs), which ends completely in mid-2013. CLOs have historically comprised more than 60% of the demand for new issues of bank loans. With a reduction in this demand, how \$550 billion will be refinanced is uncertain at this point. The quality of the bank loans that will be coming due in that time frame is also questionable, as many of the large leverage buyouts have debt maturing in this time period. Whether the recent period of refinancing bank loans in favor of term debt in the high yield bond market will be able to continue as we approach the 2012 period remains to be seen. With tighter spreads for credit possible over the next 18 to 24 months (based on supply/demand factors), the market could see its foundation begin to crumble amid the weight of the maturity schedule. We will continue to closely monitor these developments in conjunction with the actions of the buyout funds to gauge developments in this market and the likely impact on investment opportunities.

High Yield Bond and Bank Loan Maturity Schedule



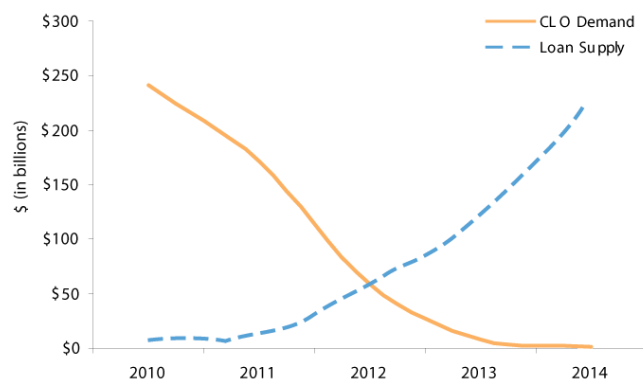
Sources: Credit Suisse, Bloomberg, Moody's, Fitch, S&P, MCM, Intex, Sigular Guff

CLO Reinvestment



Source: Sigular Guff, S&P

The CLO Re-investment Capability



Non-Traditional Distressed Opportunities

While the traditional distressed opportunity is less attractive than 18 months ago, we highlighted the potential opportunity for FDIC-related distressed transactions in the focus topic of our last *Private Capital Quarterly*, titled [*Diamonds in the Rough? Unearthing Investment Opportunities amid the Troubled Balance Sheets of FDIC-Insured Financial Institutions*](#). In the three months that have transpired since the writing of this focus topic, we are pleased to see an increase in these deals. Our research has determined that U.S. banks are in the process of removing troubled loans from their balance sheets, both with and without the FDIC's assistance. While more than 700 banks remain on the FDIC's "watch list", banks have begun to earn their way out of their problems via the steep yield curve and extremely inexpensive borrowing costs. We have spoken with several investors who have been fielding calls directly from institutions seeking transactions away from the FDIC in order to improve their capital ratios. Additionally, European banks, which many believe to be about a year behind the U.S. in addressing their balance sheet challenges, have begun to sell as well. Most investors we speak with on these matters see a "slow bleed" of investment opportunities, rather than a waterfall of opportunities witnessed in 2008 and 2009 during the credit crisis.

Securitized Markets

The securitized markets remained strong in the second quarter, despite the "flight-to-quality" rally. A review of the securities eligible for purchase by the Treasury's Public-Private Investment Program (PPIP) provides good color on securitized markets for the quarter. Non-agency residential mortgages were mixed, as prime and alt-A securities saw their median price rise during the quarter, while prices for subprime and option ARM mortgages declined. Within the commercial mortgage backed securities (CMBS) markets, all three areas of opportunity rallied, with the traditional buyer base for CMBS (i.e., long only fixed income managers) stepping back into the market in an effort to add yield to their portfolios. Through the second quarter, all eight managers in the PPIP program have net internal rates of returns in the double-digits, ranging from 13% to 37.6%. Additionally, the PPIP managers have drawn down \$16.2 billion of the \$29.4 billion of total purchasing power of the program, leaving \$13.2 billion of demand for these securities.

PPIP Eligible Securities

	Non-Agency RMB		CMBS		
	Median Price* (3/31/10)	Median Price** (6/30/10)		Median Price* (3/31/10)	Median Price** (6/30/10)
Prime	\$76.80	\$79.60	Super Senior	\$90.10	\$94.30
Alt-A	\$62.90	\$63.30	AM Tranche	\$79.60	\$82.60
Subprime	\$56.50	\$54.80	AJ Tranche	\$62.50	\$76.20
Option Arm	\$59.00	\$58.10			

*Price expressed based on par value of \$100 as of 3/31/10

** Price expressed based on par value of \$100 as of 6/30/10

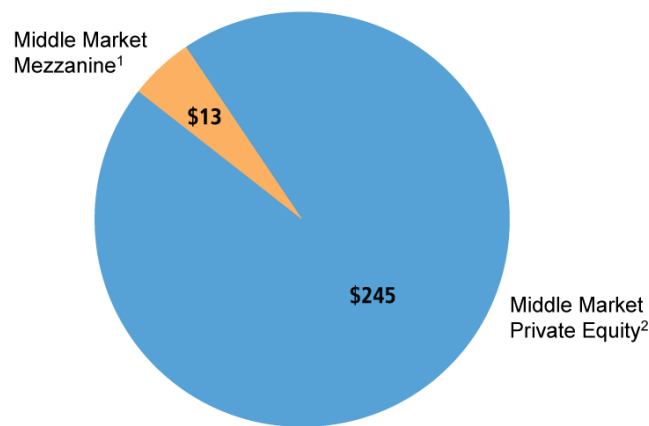
Source: U.S. Treasury Department

Mezzanine Debt

The mezzanine debt investment opportunity remains robust, as bank lending has not increased in a material fashion. Middle market private equity funds raised \$245 billion between 2005 and 2009.¹ The chart below highlights the amount of capital raised by middle market private equity versus mezzanine over the past 5 years, which amounts to a ratio of 19:1. We view this supply/demand imbalance as an opportunity favorable to middle market mezzanine lenders.

Of the \$245 billion in middle market private equity raised over the past five years, these funds have approximately \$100 billion of equity capital to deploy into new transactions. Approximately 45% of new private equity transactions will use mezzanine debt, implying that \$45 billion of investable equity will require a corresponding mezzanine investment. Equity and mezzanine debt are typically deployed in a 2:1 ratio, suggesting that \$45 billion of equity will require about \$23 billion of mezzanine debt. Middle market mezzanine funds currently have \$4 billion to deploy into new transactions versus a \$23 billion demand, resulting in a roughly \$19 billion shortfall of mezzanine debt.² Our takeaway from this data is that mezzanine lenders can be particularly choosy in this market and we see a meaningful runway of several years for investment opportunities in this space. Additionally, with yields on publicly traded high yield bonds at less than 8.5%, we see a meaningful illiquidity premium in the mezzanine debt space, and as a result, view this as a favorable opportunity.

Middle Market: Mezzanine vs. Private Equity 2005-2009
(\$ in Billions)



¹ Mezzanine funds \$500 million or less
² Private equity funds \$1.0 billion or less

Source: Thomson Financial, Prequin, Maranon Estimates

¹ Reuters, Maranon Capital

² Thomson Financial, Prequin, Maranon Capital

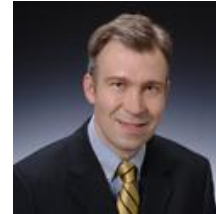
PRIVATE REAL ESTATE

After a challenging year in 2009, commercial real estate markets experienced stabilization in the first half of 2010, as transaction activity increased and property values showed slight gains. As measured on a total return basis by the NCREIF Property Index (NPI) private real estate values increased 0.8% in the first quarter of 2010. With the exception of hotels, all sectors showed marginal gains. Publicly-traded real estate securities (REITs) gained 5.6% in the first half of 2010, as companies benefited from investors' appetite for higher-yielding securities and significant progress by companies in recapitalizing their balance sheets over the course of the past year. In private real estate, transaction activity increased during the quarter, although ongoing distress across most sectors dominated the headlines. While debt capital is gradually returning from a variety of sources, significant debt maturities remain to be resolved over the coming two years. While distressed transaction activity continues, pricing for core, stabilized assets has strengthened. Write-downs in property values will likely continue through the year, driven by lower rents, rising vacancies, and assumptions for high exit cap rates.

Capital Markets

During the first half of 2010, U.S. Commercial Mortgaged Backed Security (CMBS) issuance totaled \$2.4 billion compared to \$3 billion for the full-year 2009.¹ The first half of 2010 saw the completion of single and multi-borrower CMBS offerings after a two year drought. Depending on rating, new CMBS deals were met with high demand from investors, in part due to strong underwriting and stability of the underlying assets. Investor's appetite for yield also contributed to demand for new issuances. Currently, JP Morgan Chase is leading a \$650 million offering backed by properties owned by Vornado Realty.² Additionally, some portion of the debt used to finance the \$3.9 billion purchase of Extended Stay out of bankruptcy is expected to be securitized as CMBS.³

Delinquencies on CMBS continued to rise through the first half of 2010, reaching 8.6% in the second quarter, the highest level in the history of CMBS.⁴ Loss severities on liquidated CMBS reached a historical high of 52.7%, and for certain property types, like hotels, were higher. By property type, the hotel/lodging and multifamily sectors have the highest delinquency rates followed by retail, office, and industrial.⁵



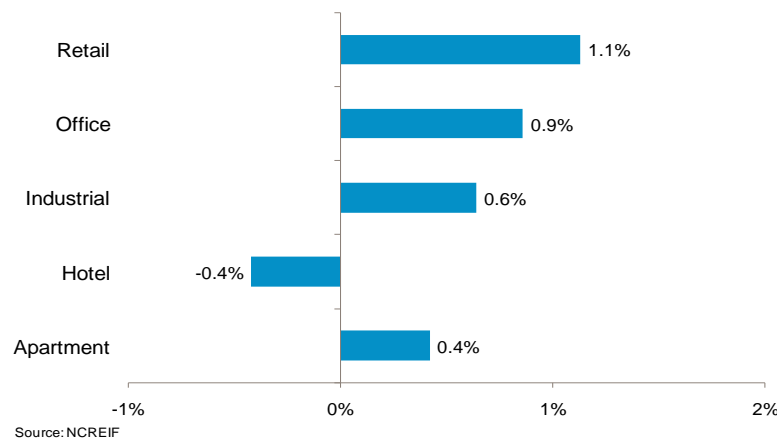
Christian Busken
Vice President

“Transaction activity increased during the quarter, although ongoing distress across most sectors dominated the headlines.”

Operating Fundamentals

Net operating income is expected to remain under pressure, particularly in the office sector due to its reliance on job growth. During the first quarter, data on rents and vacancies showed stabilization in most sectors, although vacancies remained high. As older leases expire, they will be replaced by new leases at lower market rates, which are down significantly from three years ago. The key factor in the recovery for most property types will be job growth, which remains an ongoing challenge. The returns of the NCREIF Index, however, understated actual declines in owners equity, in part, because the index includes properties without leverage. Worldwide commercial property sales volumes accelerated in the first half of 2010, but the number of properties in distress, which would include those needing to be recapitalized, or where mortgages are delinquent, was significant.

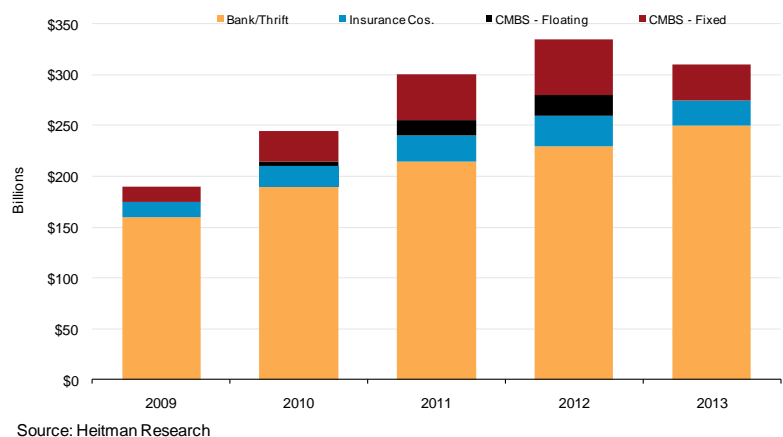
**NCREIF National Property Index Sector Returns-
First Quarter 2010**



Debt Maturities

The key issue within commercial real estate remains the large amount of debt maturing on loans taken out over the past several years when real estate values were considerably higher and financing was much easier to obtain. Over \$1 trillion in commercial mortgages are set to mature in the next four years, and how these loan maturities will be handled remains unclear. Commercial mortgage backed securities (CMBS) experienced rising delinquencies during the quarter, as property owners struggled to meet interest payments in an environment of falling rents and rising vacancies in most property sectors. Banks offered short-term extensions or loan modifications in hopes that the market improves, the “kick the can” strategy. In recent periods, bank balance sheets improved, allowing the ability to absorb losses. As such, foreclosure and workout activity increased and the opportunity set for opportunistic real estate investors is ramping up.

Commercial Real Estate Loan Maturities 2009-2013



Sectors

Apartment

The apartment vacancy rate fell to 7.8% during the second quarter, down from 8.0% at the end of the first quarter.⁶ Rents were modestly higher, showing an increase of 0.7% nationally, and net absorption was positive at 46,000 units, the strongest quarterly performance since 2005.⁷ In the best performing markets, rents increases were higher, such as in New York City, where rents rose by 1.4%.⁸ One of the key factors contributing to strong demand in the apartment sector was ongoing uncertainty in the housing market, which led many to consider renting over buying. The expiration of the first-time homebuyer credit in late April reduced incentives to move from renting to buying. Additionally, tighter lending standards for homebuyers pushed many to rental properties, further contributing to demand. Also contributing to strength in the apartments sector was the lack of available financing for new apartment construction over the past two years, which limited new supply, and should further contribute to strong pricing as demand increases. Rents declined in only 10 of 82 major markets and rent increases were strongest in major Metropolitan markets such as Boston, San Jose, and Seattle. Phoenix and Las Vegas remain among the weakest markets, with the largest year-over-year declines in rents.⁹ Going forward, the apartment sector should experience further stabilization, assuming employment improves and the economy strengthens.

Office

Office vacancies climbed in the second quarter, with the national vacancy rate reaching 17.4%, the highest level since 1993.¹⁰ Average effective rents (defined as net amount paid by tenants after landlord concessions) continued to decline in the second quarter, falling by nearly 1%, to an average of \$22/square foot.¹¹ This represented a more moderate decline than the past year and there are indications that rents and vacancies have stabilized near current levels. Weakness in the office sector was largely driven by anemic job growth, as companies were slow to hire and unemployment remained near 10%. The most distressed markets within the office sector (Las Vegas, Phoenix, and Detroit) had vacancy levels in excess of 25%, while Washington, D.C. and New York City had significantly lower vacancies, in the 10-12% range.¹² New York benefited from increased hiring in the financial services sector, while Washington D.C. saw growth in demand from expansion in the Government.¹³ Returns in the office portion of the NCREIF Property Index sector declined 0.9% in the first quarter, second only to the retail sector, which declined 1.1%. The office vacancy rate is expected to peak in 2010, but any recovery will be a function of job growth, which may not materialize until 2011. Therefore, the office sector will likely lag other property types in terms of recovery.

Industrial

Demand in the industrial sector is driven primarily by inventories, manufacturing, imports, and exports. The global recession, combined with a drop in consumer demand, negatively impacted industrial property fundamentals in the downturn. In the first half of 2010, however, signs of stabilization appeared, but fundamentals remained challenging. Net absorption was negative at 5.5 million square feet in the quarter, but this represented an improvement over prior quarters. Some major industrial markets, such as Los Angeles, Dallas, and Houston, experienced positive net absorption during the quarter. Industrial vacancy rates stood at nearly 14% nationally, a 20-year high, but certain markets (Los Angeles -10%) were significantly lower. Alternatively, Atlanta had the highest vacancy rate at 20%. On the positive side, however, conditions appear to be stabilizing and the sector should benefit from limited new supply, as new construction has been severely limited over the past two years due to a lack of available financing. New completions in 2010 are expected to be approximately 31 million square feet, down significantly from the peak when completions exceeded 100 million square feet in 2007 and 2008.

Retail

Fundamentals in the retail sector weakened during the second quarter, as vacancies rose and lease rates fell, driven by slower consumer spending that limited expansion by retailers. Vacancies at major malls in the top U.S. markets rose to 9% in the second quarter, up from 8.9% at the end of the first quarter.¹⁴ Rental rates at malls fell slightly (0.2%) to an average of \$38.75/square foot.¹⁵ Similarly, vacancies at strip centers rose to 10.9% during the quarter, up from 10.8%. Rental rates declined by 0.5%.¹⁶ Due to the longer-term nature of retail leases, the sector could lag any recovery in the broad economy and vacancy rates could remain elevated for the next several years. Same store sales rose in the first quarter, but gains were muted in the second quarter, particularly home improvement stores and discount retailers. Grocery store-anchored shopping centers remained stable and were less impacted by the downturn due their exposure to sales of consumer staples.

¹ Marcus & Milichap Research Services, July 10, 2010

²⁻³ Lingling Wei, CMBS Market Rises from the Ashes of Collapse The Wall Street Journal July 21, 2010

⁴⁻⁵ Bodamar, David, CMBS Delinquencies Rise Again, but Pace of Growth Slows. Retail Traffic Magazine, July 6, 2010

⁶⁻⁹ Timiraos, Nick Apartment Vacancies Fell in Quarter The Wall Street Journal, July 8, 2010

¹⁰⁻¹³ Troianovski, Anton, Office Vacancy Rate Keeps Climbing The Wall Street Journal, July 6, 2010

¹⁴⁻¹⁶ Hudson, Kris Shopping Centers Struggle, but Hope Seen The Wall Street Journal, July 7, 2010

NATURAL RESOURCES: TIMBER

Timberland investments, as measured by the NCREIF Timberland Index, outperformed the broad equity markets with a return of 1.0% in the second quarter of 2010.¹ Transaction activity in the timberland markets was limited during the second quarter, as most publicly-traded paper and forest products companies had few properties available for sale.² Among financial buyers and sellers, however, there was more transaction activity. Hancock Timber Resource Group sold 30,000 acres in Florida to another timber investment management organization (TIMO). Similarly, Forest Capital Partners sold 70,000 acres in Louisiana to another TIMO.³ The most anticipated transaction remains International Paper's 'Blue Sky' timberlands, which includes 143,000 acres of timberland assets. The deal failed to close after American Timberlands was unable to secure the required capital. International Paper is expected to continue to market the properties and a sale is expected sometime later this year.⁴ There are currently few large-scale timberland transactions on the market, although a number of smaller properties are expected to sell during the second half of the year.

Ongoing distress in the in the U.S. housing market continued to adversely affect pricing for building-related lumber products, such as paneling and framing.⁵ Following the expiration of the homebuyer tax credit in late April, pricing and residential housing transaction activity declined into the summer months. Hot and dry weather in the U.S. South provided favorable logging conditions, increasing supplies at mills and resulting in a slight decrease in pine saw timber during the quarter.⁶ Prices for Northern hardwoods (Black Cherry and Maple) also declined during the quarter, again a function of improved logging conditions.⁷ In the Northwest, average prices for Douglas-fir logs increased 17%, largely a function of strong demand from Asia, which offset weaker demand in the U.S.⁸ Finally, pulp prices rose during the quarter, reaching all time highs due to limited supplies following the earthquake in Chile.⁹ Weakness in the residential housing market continued to weigh on the forest products industry.



Christian Busken
Vice President

“Ongoing distress in the in the U.S. housing market continued to adversely affect pricing for building-related lumber products such as paneling and framing.”

¹⁻⁹ Forest Investment Associates Quarterly Update – Second Quarter 2010.

NATURAL RESOURCES: ENERGY

Crude oil prices finished the quarter at \$75.63, a 10% decline from the end of the first quarter. The decline in oil prices was driven by concerns about slower global economic growth and expectations that the fiscal crisis in Europe could negatively impact demand in the second half of the year. During May, crude oil prices fell 21%, as the European debt crisis deepened. Strength in the U.S. dollar versus major currencies also contributed to lower prices, as oil is denominated in U.S. dollars. Despite the second quarter decline, fundamentals for oil remain strong, as demand from emerging markets continues to grow and OPEC spare production capacity is limited. Additionally restrictions on offshore drilling arising from the BP oil disaster in the Gulf of Mexico could provide support to prices going forward.

Conversely, natural gas prices rose 20%, finishing the second quarter at \$4.60/mmbtu, up from \$3.90/mmbtu at the end of the first quarter. Gas prices moved higher amid forecasts of hotter-than-average summer weather and expectations for an active hurricane season. While natural gas supply growth from new “unconventional” resource plays continues to increase, these wells are uneconomic at prices below \$4.00/mmbtu, creating a theoretical floor on gas prices. Despite recent gains, natural gas prices remain significantly below their peak level of \$13.70 in mid-2008. Analysts expect abundant natural gas supplies to keep prices in check through most of the year, although questions about the sustainability of production from new “unconventional resources” remain a key factor in the long-term natural gas outlook. After declining 50% in late 2008 and early 2009, drilling activity (as measured by rig counts) recovered, particularly for horizontal rigs, which are back near peak levels. The natural gas drilling rig count increased as producers sought to establish production on properties acquired at the peak of the market prior to the expiration of leases on these properties.



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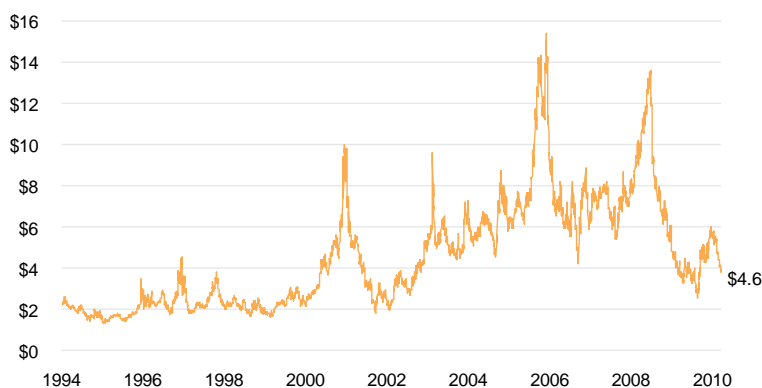
“Transaction activity in the energy sector continued in the first half of 2010, with many private equity energy funds experiencing realizations through sales of portfolio companies.”

Crude Oil Price per Barrel



Source: Energy Information Agency

Natural Gas Price per Million BTU



Source: Energy Information Agency

Private Energy Funds

Transaction activity in the energy sector continued in the first half of 2010, with many private equity energy funds experiencing realizations through sales of portfolio companies and initial public offerings. In mid-June, Houston based Oasis Petroleum raised \$588 million in the largest initial public offering of the year in the energy sector. Backed by private equity firm EnCap Investments, Oasis owns unconventional oil fields in North Dakota and Montana, and is expected to use the proceeds of the offering to fund drilling projects.¹ Additionally, in early April, Denbury Resources Inc. announced the sale of a portion of its oil and natural gas properties to Quantum Resources Management, a large working interest private energy fund. The properties were acquired in the merger with Encore Acquisition Co. for \$900 million. Many publicly traded exploration and production companies significantly reduced their capital expenditures during 2009, but producers are expected to increase budgets in 2010, as higher commodity prices provide additional cash and access to the capital markets has improved over the past year.

Distress and liquidity issues have been mostly absent within private energy funds up to this point, due to the fact that most private-equity backed companies have stable sources of financing (which are based on reserve values), limited leverage, and many have hedges in place on existing production, mitigating the impact of declines in commodity prices. Some private energy strategies focused on “lease and drill” activities (with little or no production), have suffered from the downturn in natural gas prices over the past 18 months. The expected wave of distressed acquisition opportunities largely failed to materialize, as forced sales were limited and banks avoided foreclosing on assets, while others were “bailed out” by rising commodity prices. Those managers with hedges in place on existing production continued to benefit from prudent risk management and realized higher prices on sales of existing production. Year-end valuations reflected the impact of new drilling activity, existing production, commodity prices, and hedge positions.

¹ Spears, Lee Oasis Petroleum Rises After Second Biggest U.S. IPO, Bloomberg Businessweek, June 17, 2010.

DISCLOSURES

Indices:

Russell Investments rank U.S. common stocks from largest to smallest market capitalization at each annual reconstitution period (May 31). The primary Russell Indices are defined as follows: 1) the top 3,000 stocks become the Russell 3000 Index, 2) the largest 1,000 stocks become the Russell 1000 Index, 3) the smallest 800 stocks in the Russell 1000 Index become the Russell Midcap index, 4) the next 2,000 stocks become the Russell 2000 Index, 5) the smallest 1,000 in the Russell 2000 Index plus the next smallest 1,000 comprise the Russell Microcap Index.

S&P 500 Index consists of 500 stocks chosen for market size, liquidity and industry group representation, among other factors by the S&P Index Committee, which is a team of analysts and economists at Standard and Poor's. The S&P 500 is a market-value weighted index, which means each stock's weight in the index is proportionate to its market value and is designed to be a leading indicator of U.S. equities, and meant to reflect the risk/return characteristics of the large-cap universe.

Morgan Stanley Capital International – MSCI - A series of indices constructed by Morgan Stanley to help institutional investors benchmark their returns. There are a wide range of indices created by Morgan Stanley covering a multitude of developed and emerging economies and economic sectors.

Barclays Capital Fixed Income Indices – an index family comprised of the Barclays Capital Aggregate Index, Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, Municipal Index, High-Yield Index, and others designed to represent the broad fixed income markets and sectors within constraints of maturity and minimum outstanding par value.

The FTSE NAREIT Composite Index (NAREIT Index) includes only those companies that meet minimum size, liquidity and free float criteria as set forth by FTSE and is meant as a broad representation of publicly traded REIT securities in the U.S. Relevant real estate activities are defined as the ownership, disposition, and development of income-producing real estate.

The HFRI Monthly Indices (HFRI) are equally weighted performance indexes, compiled by Hedge Fund Research Inc., and are used by numerous hedge fund managers as a benchmark for their own hedge funds. The HFRI are broken down into 37 different categories by strategy, including the HFRI Fund Weighted Composite, which accounts for over 2000 funds listed on the internal HFR Database. The HFRI Fund of Funds Composite Index is an equal weighted, net of fee, index composed of approximately 800 fund of funds which report to HFR. See www.hedgefundresearch.com for more information on index construction.

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