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Editor's Letter

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U.S. equity markets have provided a near 30% return so far this year, reaching new highs monthly. Contributing to this rise are low interest rates and ample liquidity—and, from a longer-term and more fundamental perspective, continuing strong growth in the U.S. manufacturing industry. Growth in U.S. manufacturing is being spurred by the adoption of new technologies that boost productivity and competitiveness. Continued strong U.S. gross domestic product (GDP) growth has increased U.S. imports, transmitting economic growth to other economies. This has helped to stimulate rising equity market prices globally. As discussed in this issue of *The Journal of Private Equity*, the performance of venture capital and private equity is related to the performance of real GDP in developed countries.

The application of new technologies to manufacturing has been the primary cause of falling employment in the manufacturing sector since 1980. However, increasingly, the U.S. manufacturing sector is facing a growing shortage of skilled workers who can put the new automation to optimal use. Furthermore, only a few educational institutions offer the correct courses for educating the required skilled workers. Immigration of the needed skilled workers is becoming more uncertain, and the acceptance of women to fill these needs is only slowly changing.

A second and more imminent concern is that the drivers needed to support sustainable real U.S. GDP growth may not continue. Inflation fears based on excess liquidity in the U.S. economy could result in a more restrictive monetary policy by the Federal Reserve. The Federal Reserve has already indicated that it is beginning to sell its holdings of private sector securities, which were purchased to halt the Great Recession. Such sales will reduce liquidity and put upward pressure on interest rates and could limit further expansion in the U.S. real GDP growth rate beyond its defined current full-employment rate of growth. Slower U.S. growth would adversely affect the recovery being experienced in other economies.

New venture expansion and private equity portfolio acquisitions, restructurings, and turnover are aided by strong real economic growth. A low interest rate environment with relatively easy access to bank loans has facilitated the financing of restructurings of companies acquired by private equity companies. Thus, new venture investments and private equity activity could be adversely affected with a tighter monetary policy. This might be offset if there were additional expansionary fiscal policy in the form of increased public-sector spending on infrastructure or defense, a reduction and simplification of corporate taxes, and/or a significant reduction in government regulations. However, with the current politicians in Congress unwilling to agree on what changes would benefit the economy and its corporate and private citizens, the chance of any significant policy changes by the administration appear to be in limbo. Even so, venture capital and private equity are better organized to perform well over the long run because they are helped by a backup source of liquidity in the form of a secondary market infrastructure (see "Snapshot on VC Secondary Market" in this issue) that provides them a way to bunch and sell assets before planned maturity. This enables venture capital and private equity companies to replenish their liquidity and gives them the ability to invest in more-promising new opportunities and underperforming companies. In this way, they are able to continue to support the upgrading of the application of new technology and automation of U.S. manufacturing to further enhance the U.S. economy with more competitive industries.

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In this issue of *The Journal of Private Equity*, we have a number of very thoughtful articles that focus on various sectors of the venture capital and private equity markets. The first three articles update the study of the volatility and strength of growth of private equity performance.

We start with Jeff Hooke and Ken Yook and their article "The Curious Year-to-Year Performance of Buyout Fund Returns: *Another Mark-to-Market Problem?*" As they point out, buyout funds are essentially leveraged portfolios of a certain kind of U.S. company (i.e., a small-cap, low-tech, nonfinancial, nonutility, consistent generator of earnings before interest, taxes, depreciation, and amortization with moderate cyclicality). These characteristics enable lenders to provide high debt levels with a reasonable expectation of repayment. Recent academic studies have raised doubts regarding the alpha of buyout fund returns against mimicking publicly traded portfolios, and buyout investors have sometimes responded that lower returns are offset by the funds' lower volatility relative to public stocks.

Regarding the volatility of such returns, several studies have used a cash-flow-only estimation approach (CFOE) to calculate risk, as an alternative to relying on (1) actual cash flows paid to limited partners and (2) the asset valuations of unsold investments as determined by buyout fund general partners. These studies suggest that buyout funds' reported return volatility is understated, relative to times-series public market equity returns. Hooke and Yook use a different methodology (i.e., other than CFOE) to evaluate buyout fund return volatility. They use a publicly traded–mimicking portfolio, adjusted for buyout-type leverage, to measure risk and conclude buyout fund returns are more volatile than public equity market returns.

Daniel Steger analyzes "Macroeconomic Conditions and Private Equity Fund Returns—*A Swiss Perspective*" using a hand-collected dataset of 531 private equity funds. His analysis shows that macroeconomic conditions influence private equity fund returns. He finds that weak economic growth, low corporate bond yields, and low stock market valuations during the period when investments are taking place favor returns. A positive change in economic growth and rising stock market valuations over the lifetime of a fund supports private equity fund returns. In terms of the importance of specific performance indicators, changes in corporate bond yields and GDP growth during the investment period together explain between 9% and 29% of the variance of the internal rates of return. These results are consistent with prior research.

The results of a second study of drivers of performance undertaken by Manu Sharma, Puneet Gupta, and Rouhi Gopal is presented in "Global GDP Drivers of U.S. Venture Capital Index." This study examines the relationship between the U.S. Venture Capital Index and the GDP growth rates of eight major world economies, which include the United States, the United Kingdom, Switzerland, Japan, Germany, France, Canada, and Australia. The analysis involves reducing the dataset to two explanatory components that best explain the variation in the dataset. Next, the authors analyze the robustness of the relationship between the U.S. Venture Capital Index and the extracted components representing the GDP growth rates of major economies. The result establishes that the U.S. Venture Capital Index has a high positive correlation with the two explanatory variables. Furthermore, these explanatory variables are found to represent more than 40% of the variation in GDP growth rates.

Shifting focus to sources of fundraising for private equity investments, Arunachal Khosla and Puneet Gupta examine the emerging role of "Family Offices—*The Indian Perspective*." Family businesses in India have been major contributors to the economic growth of India. As more wealth is generated by these family businesses, there emerges a need to manage and conserve the wealth more effectively, efficiently, and prudently. This article studies the challenges faced by Indian family businesses and discusses the emerging role played by family offices in private equity investment in India. (The next issue of *The Journal of Private Equity* will explore the development of U.S. family offices and their attitude toward private equity investments).

From the perspective of limited partners and other private equity investors, Kevin A. Diehl illustrates "How a Tax Rule Can Enable Greater Due Diligence Before Fully Consummating a Private Equity Deal." Normally, significant time and money are expended in due diligence before engaging in a private equity deal. However, the most important and informative item to consider is generally overlooked. The corporation's income tax returns are usually confidential, but Internal Revenue Code § 6103(e)(1)(D)(iii) allows a corporate shareowner who has only 1% ownership to request a copy of the company's tax return directly from the Internal Revenue Service. Thus, if all the other due diligence checks out, the final step should be to acquire a 1% interest to gain the ability to view the corporation's tax return. Tax returns are the windows to the souls of corporations. What accounting financial reporting can hide cannot be hidden in a tax return to the federal government. Private equity investments would be safer for studying tax return information. No insider-trading charge should accrue, but the possibility of this claim should be weighed as a cost against this benefit.

Developing opportunities in different industries and different countries that might be of interest to venture capital and private equity investments are the focus of the next five articles. Paul Crowe, in his article "Pharmacoeconomics: *Growth in Cancer Diagnostics Means Market Opportunity*," examines the testing for precision diagnostics in cancer that are underway in U.S. Food and Drug Administration clinical trials. This new technology will outdate current, inaccurate technologies (e.g., mammograms and prostate-specific antigen tests) and become part of routine health screenings. Cost savings translate to bigger profit potential for the hospitals and laboratories that conduct the tests. Trends in precision medicine will turn the diagnostics sector from its current moderate value/moderate growth status to one that replicates the explosive growth of biotech.

Arsalan Ali Farooquee studies "Investing for Universal Energy Access." More than 1.2 billion people are without access to electricity. Universal energy access is a challenging goal. However, the growth of mobile phones and the microfinance industry reveals the potential of rural markets. This article discusses an investment perspective for universal energy access and examines the case for private capital in decentralized renewable energy.

Jarunee Wonglimpiyarat examines "FinTech Crowdfunding of Thailand 4.0 Policy." This study explores the challenges of a FinTech crowdfunding platform in Thailand. Under the policy of moving the country toward Thailand 4.0, the Thai government has placed importance on a value-based and innovation-driven economy. An empirical analysis, based on the national innovation system approach, shows that the Thai government plays a key role in building a crowdfunding platform to provide entrepreneurial finance for start-ups. The findings indicate the barriers both at the policy and operation levels underlying the Thai financial innovation system. The analysis provides insightful lessons and implications to strengthen the FinTech crowdfunding platform for promoting knowledge-intensive economic growth.

Next, Jarunee Wonglimpiyarat returns to analyze "Tax-Based Mechanisms: *Technology Development of Singapore and Thailand*." High-tech small- and medium-sized enterprises are important in enhancing the innovative capacity of a nation. This article analyzes the tax policies and research and development tax incentives enacted to promote technology commercialization in the cases of Singapore and Thailand. The analysis focuses on the governmental dimension of Porter's diamond model. The study offers insightful lessons for investors, linking tax policy to the perspective of science and technology policy. The policy implications might also be a useful model for other developing economies in shaping the direction of their national innovation system.

Poonam Dugar and Nirali Pandit present an updated perspective on the "Growth of Venture Capital and Private Equity in India." Venture capital and private equity (VCPE) investments have been evolving as a potential source of corporate finance, forming a part of India's emerging story from its beginning. This study analyzes the factors affecting the growth trends of VCPE investments in India from 1998–2016 in terms of the value of investments and number of deals and the penetration of VCPE investments across various industries. At the current pace of development of equity, bonds, external commercial borrowings, and bank credit pools, VCPE investments will have to double to fund the government's growth targets.

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