Targeted Investing: Financial and Collateral Impacts

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Abstract
This paper argues that pension funds and other investors who wish to target their investments can earn attractive risk-adjusted rates of return that seek to fill capital gaps in the market, and that by doing so they can benefit their communities as a whole. Targeted investing focuses on a particular type of investment, usually private equity or real estate that tries to achieve both a financial and a social return. We examine the California Initiative of the California Public Employees Retirement System (CalPERS) as a model of targeted investment. We conclude that best practice in pension fund targeted investment is achieved through geographic rather than social targeting. We believe that when investors limit themselves to a strictly geographic focus, their primary concern is market rates of return.

We test the impact of geographic targeting using MacDonald and Associates data on Canadian private equity investments exited between 1999 and 2005. We compare exited deals where at least one of the investment partners had a stated geographic target against investments with no geographic targeting. The findings indicate no difference between targeted and untargeted firms in terms of age of firm at the time of investment, industry sector, market capitalization (at time of IPO), exit type, time between investment and exit.

From this case study we draw lessons for Canadian pension funds interested in pursuing targeted investing.

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# Table of Contents

1. Introduction 3

2. Theoretical Argument 4

3. Overview of involvement in underserved capital markets 8
   3.1. Private Equity and Pension Funds 8
   3.2. Pension Funds and Underserved Markets 10
   3.3. Methods and Vehicles for Urban Economic Development 10

4. CalPERS’ Involvement in Underserved Capital Markets 12

5. The California Initiative 16
   5.1 Early Development 16
   5.2 Impacts 20

6. Best Practice Results 24
   6.1. Preliminary Best Practice Findings 24
   6.2 The California Initiative as a Best Practice Case 25

7. Testing the Impact of Geographic Targeting 27
   7.1 The sample 27
   7.2. Methodology 28
   7.3. Results 30
   7.4. Tests of Success Factors 31
   7.5 Implications 36

8. Implications for Canadian Pension Funds and Public Policy 36

References 39
1. Introduction

This paper argues that pension funds can earn attractive risk-adjusted rates of return on targeted private equity investments that seek to fill capital gaps in the market, and that by doing so they can benefit their communities as a whole. Targeted investing focuses on a particular type of investment in order to achieve both a financial and a social return. The terminology that is used to refer to targeted investing ranges from ‘Economically Targeted Investments’ to ‘investments in underserved capital markets’ or ‘investing with intent’.

Although targeted investing may be done for any type of investment, the focus of this paper is on targeted investments in private equity instruments. It is clear that there are inefficiencies in the private equity market. Theoretical evidence suggests that these inefficiencies can be exploited to create appropriate returns. At the same time, such investments can create collateral benefits, such as urban revitalization and increased employment opportunities. There are a number of targeted investment approaches within the private equity field, including funds-of-funds and commingled funds. The key is to find best practices that pension funds can use in order to successfully implement targeted investment programs that can benefit both the fund and the community.

In 1992, the California Public Employees Retirement System (CalPERS) began to target investment in the State of California as part of its overall investment policies. One of the programs adopted as part of this goal is the private equity California Initiative. We examine the California Initiative as a model of targeted investment. We conclude that best practice in pension fund targeted investment is achieved through geographic rather than social targeting. We believe that when investors limit themselves to a strictly geographic focus, their primary concern is market rates of return with collateral impacts as a secondary result from the investment.

We test the impact of geographic targeting on investment portfolios using MacDonald and Associates data on Canadian private equity investments exited between 1999 and 2005. We compare exited deals where at least one of the investment partners had a stated
geographic target against investments with no geographic targeting. The findings indicate no difference between targeted and untargeted firms in terms of age of firm at the time of investment, industry sector, market capitalization (at time of IPO), exit type, time between investment and exit. From this case study we draw lessons for Canadian pension funds interested in pursuing targeted investing.

This case study is presented in the following manner. Section two examines the theoretical arguments in favour of targeted investing and urban economic development strategies. Section three presents an overview of current pension fund involvement in private equity in general and in underserved capital markets in particular. Section four looks at CalPERS’ involvement in underserved capital markets, while section five focuses on the California Initiative. Section six looks at the best practice results that can be drawn from this case study. Section seven tests the impact of geographic targeting on investment portfolios. Lastly, section eight draws implications for Canadian pension funds and public policy and section eight provides some concluding arguments.

2. Theoretical Argument

Michael Porter has noted that the North American system of allocating investment capital is failing. This system, as compared to the Japanese or German systems, is less supportive of equity investment overall, favours those forms of investments for which returns are most easily measurable, and encourages investment in some sectors while limiting investment in others (Porter, 1992). In particular, Porter has argued that institutional sources of equity capital have often ignored inner city opportunities and minority owned businesses (Porter, 1995). In the Harvard Business Review, he noted that “Access to debt and equity capital represents a formidable barrier to entrepreneurship and company growth in inner city areas” (p.64, Porter, 1995). In essence, he describes an important urban capital gap.

Similarly, Jeffrey Sohl (2003) notes that the U.S. private equity market in particular does not meet the standards for market efficiency. He describes two major capital gaps in the
private equity industry: one at the one hundred thousand to two million dollar range; and the other between two and five million dollars (see table 1 below).

Table 1

**Equity Capital for Entrepreneurs**

<table>
<thead>
<tr>
<th>Stage</th>
<th>Source</th>
<th>Pre-seed</th>
<th>Seed/ Start-Up</th>
<th>Early</th>
<th>Later</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Founders</td>
<td>Angels/ Angel Alliances</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Demand</td>
<td>$25 K</td>
<td>$100 K</td>
<td>$2,000 K</td>
<td>K</td>
<td>$5,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>funding gap</td>
<td>secondary funding gap</td>
<td></td>
<td>$&gt;5,000</td>
</tr>
</tbody>
</table>

Source: Centre for Venture Research - University of New Hampshire, as presented in Sohl, 2003

Porter and Sohl are not alone in the view that capital gaps are present in the market to fund private enterprise. Many authors have found different types of capital gaps which explain why underserved capital markets exist. The capital gaps described by Porter are geographical in nature, describing capital gaps in inner cities relative to other regions. Lipper and Sommer (2000) similarly describe ‘have’ versus ‘have-not’ States with respect to the availability of venture capital investments. The capital gaps described by Sohl are related to the amount of capital required by the business, as are those described in articles by Davis (2003), Freear et al. (2002), and Mason & Harrison (2003). Other reasons why underserved capital markets exist include: prejudice, making it more difficult for minority business owners to obtain capital (Garvin, 1971); information gaps, both for businesses seeking capital and for capital providers (Sohl, 1999; Freear et al, 2002); and capital provider preferences for some sectors over others (Patterson, 1993; Porter, 1992). Evidence of capital gaps has been found in many countries, and this phenomenon is well documented in the United States, Canada, and the United Kingdom (Harrison & Mason, 2000; Sohl, 1999; Davis, 2003; Freear, Sohl, and Wetzel, 2002).
The existence of such underserved capital markets is, in fact, one of the strongest arguments in favour of Economically Targeted Investments (ETIs). Indeed, ETIs are often defined as investments that fill a capital gap or infuse capital into an underserved market, while both delivering an appropriate risk-adjusted rate of return and providing collateral benefits (Zanglein, 2001; Quarter et al., 2001; Read, 1997). Porter’s arguments would particularly support the creation of urban economic development strategies, such as the California Initiative. He described four major advantages to inner city investing, including: strategic location, since they offer proximity to business areas, etc.; local market demand, since these markets have not yet been saturated; integration with regional clusters; and the availability of human resources (Porter, 1995). Similarly, all of the different types of capital gaps described represent opportunities for pension funds to achieve desirable returns through targeted investing.

Opponents of ETIs suggest that investments that are not already being funded must be inferior (Notsinger, 1998) and insist that there is little evidence to suggest that markets are inefficient (Barth and Cordes, 1981). Nonetheless, although Barth and Cordes (1981) argue that markets are not inefficient and that therefore ETIs are not useful, they also note that “If capital markets actually failed to efficiently allocate funds to such activities, pension funds might actually earn higher returns by diverting a larger share of their portfolios to, say, venture capital or urban housing investments.” (p. 236)

In fact, the widely documented existence of capital gaps as found in the general private equity literature, and as described above, suggests that the private equity market is not efficient. There are currently many imperfections in the private equity market (Sohl, 2003). Further, this inefficiency, resulting in a lack of private equity, can hurt the economic development of a region (Lipper & Sommer, 2000).

The major concern for pension funds and other institutional investors when considering investment in ETIs is that of their fiduciary duty to provide a reasonable risk-adjusted rate of return to their beneficiaries. For this reason, many researchers have looked at the ability of ETIs to provide a reasonable rate of return. Unfortunately for this debate,
evidence thus far on whether it is possible to consistently realize appropriate returns has been divided.

Gregory (1990) found that the performance of ETIs was indeterminate; one third of the public employee pension plans with ETIs that he studied met their benchmark returns, 4% failed, and 3% exceeded benchmarks. The rest either did not know or did not answer the question.

Notsinger (1998) notes that even if the market to finance these investments is inefficient, fund managers may be unable to distinguish between good investments and those that are overpriced. His research examined a number of pension funds both with and without ETIs and found that, overall, those without ETIs earned statistically significantly higher abnormal returns than funds with ETIs. However, the difference in returns between those that invested in ETIs and those that did not was not statistically significant when divided into the three individual annual surveys. He concluded that “…pension funds that invest in ETIs experience lower risk-adjusted rates of return than funds that do not invest in ETIS.” However, referring to the amounts of the differences, he also noted that “These estimates are probably too large to blame solely on ETIs because these investments typically make up only 5% of a pension fund’s portfolio” (pg. 94). Marr et al. (1994) also concluded that ETIs (as used by pension funds) had consistently underperformed accepted benchmarks.

In contrast, Watson (1994) found that ETIs may improve the performance of pension funds. Similarly, to investigate the question of whether ETIs allow investors to realize appropriate risk-adjusted returns, Doran & Bannock (2000) investigated examples of locally targeted funds that institutional investors were supporting. They found that there were local gaps in the availability of venture capital and concluded that locally targeted private equity can be a profitable investment opportunity for public sector funds. The performance of the funds they examined was at least comparable with that of private venture capital funds; they noted that there need be no compromise between the objective
of supporting local economic development and that of seeking the highest financial returns.

Although the evidence on whether or not ETIs have been able to provide adequate risk-adjusted rates of return in the past is divided, theoretical evidence suggests that this should be possible. Porter argued that, following the principles of competitive advantage, inner-city based businesses would allow investors to receive appropriate returns on their investments (Porter, 1995). Capital gaps based on amount of funding, prejudice, location, sector, etc. all represent opportunities for pension funds to address market inefficiencies. Given that there are documented capital gaps in the market for private equity, pension funds should be able to use ETIs to fill these gaps while earning an attractive risk-adjusted rate of return and fulfilling their fiduciary duties.

3. Overview of current pension funds involvement in underserved capital markets

3.1. Private Equity and Pension Funds

Pension fund involvement in private equity and other non-traditional investments has increased in recent years (Davis, 2003; Greenwich and Associates, 2002). Pension funds are turning to alternative investments such as private equity because this type of investment is often able to outperform more traditional investments, with expected returns of, on average, fifteen percent (Healey, 1997). Another reason that alternative investments may be viewed as attractive is the additional portfolio diversification that they provide; for instance, venture capital is not closely correlated to the broad stock market (Healey, 1997).

However, although involvement in the private equity market by pension funds in both Canada and the United States is increasing and is large in terms of dollar value, it remains small as a percentage of total portfolio assets within the pension funds themselves (Greenwich and Associates, 2002; Chemla, 2004). Healey (1997) found that, in 1995, the largest funds in the United States and Canada had almost $70 billion committed to private equity. Nonetheless, Chemla (2004) found that, although over half of the investments in Venture Capital funds in 2001 came from pension funds, this number
represented less than five percent of pension fund assets. There is also clear evidence that American pension funds contribute more capital to venture capital and private equity than do Canadian pension funds (Davis, 2003; Chemla, 2004; Industry Canada, 2004).

The hesitance of many pension funds to participate in these alternative investments may be attributed to a number of challenges. For instance, private equity investments are essentially illiquid and exits may be difficult (Chemla, 2004; Healey, 1997). In addition, they may be perceived as inherently ‘more risky,’ even when this is not the case (Healey, 1997). Pension fund trustees may also be concerned about the due diligence requirements for these investments, the need for expert advice, and the fact that reliable data may be difficult to obtain (Industry Canada, 2004; Healey, 1997). Small and medium size institutions in particular have structural limitations in terms of gathering this information and performing due diligence (Industry Canada, 2004).

Davis (2003) notes in his overview of the Canadian venture capital market that, in the U.S., “VCs and pension fund managers developed best practices, third-party pools, private placement databases providing market information, and “a human resources component producing diverse investment specialists, intermediaries, market experts (known as gatekeepers) who act solely on behalf of fiduciary interests, and deal-making agents” (Falconer 2000)” (p.201) that Canada can learn from. A recent Industry Canada report seconds this sentiment, noting that funds of funds, gatekeepers and other tactics can help pension funds to overcome structural barriers to private equity investing (Industry Canada, 2004).

These suggestions should not just apply to Canadian pension funds looking to emulate the more experienced American market. The fact remains that private equity and other alternative investments are not widely invested in by pension funds in either country. There are, however, a few American funds, such as CalPERS, that do have a lot of experience in these areas, and specifically in serving underfunded capital markets. It is to these funds that other funds can look to for best practices.
3.2. Pension Funds and Underserved Markets

Urban economic development strategies have undergone a dramatic transformation over time, making them increasingly attractive to savvy pension fund investors. Initially conceived as economically targeted investments (ETIs), urban economic development was valued as a collateral benefit exogenous to the investment returns. This first generation of projects focused on capital preservation combined with collateral benefits as the principle aim of the investment, with acceptable low rates of return guaranteed through government involvement. By the mid 1990s first generation ETIs co-existed with second-generation projects. In these new projects urban economic development is endogenous to the rates of return, with resulting investment risks managed through the structure of the private partnerships rather than a reliance on government guarantees. While risks are higher in these projects, so are the potential returns from investment. A third generation of urban economic development investment projects is now being entered and is potentially the most dynamic phase along this continuum. Urban development in this phase is regarded as an economic opportunity, and the investment is a pure venture capital structure determined solely by potential rates of return. The spill over from urban revitalization impact is a positive but not essential driver (see schematic diagram). The Center for Emerging Domestic Markets estimates ten large pension funds, eight of which are public sector funds, currently have $3 billion invested in third generation urban development projects. The CalPERS California Initiative modelled on the second and third generation approaches to urban economic development offers interesting lessons for these kinds of engagements.

3.3. Methods and Vehicles for Urban Economic Development

There are many ways in which pension funds can participate in urban economic development through private equity. The level of involvement required by the fund ranges anywhere from a simple investment in a previously established outside fund that meets their development goals to an internally managed direct private placement of equity in a specific firm (Cross, 1992). However, for the most part investments fall in between these two extremes. Commingled funds with professional management are one of the most successful ways of structuring ETIs; these are pooled investments that
(usually) several pension funds participate in, and which are run by hired outside managers (Calabrese, 1999).

Consortiums are a very useful way to overcome structural barriers, by pooling the resources of several pension funds to undertake investments together (Yago et al, 2003). Partnering with private investors is also beneficial, as it provides a way for pension fund managers to confirm — for themselves, for regulatory bodies, and for their beneficiaries — that risk-adjusted returns, diversification, due diligence, etc. are comparable to what might be achieved using other investments (Calabrese, 1999). Partnerships of pension funds with intermediaries allow the funds to avoid dealing directly with the details of due diligence etc. while still ensuring that the investments are well managed (Yago et al, 2003) Bringing private management to investments with a public benefit can help to ensure that both the direct financial goals and the collateral economic development benefits are achieved.

One example of how consortiums and partnerships can work is through the creation of pooled funds that allow investors to spread their risk over more companies while still achieving economic development goals in their own community (Yago et al, 2003). For example, the Department of Housing and Urban Development worked in cooperation with six pension funds to establish a program enabling pension funds to invest in low-income housing (Rosentraub and Shroitman, 2004). Similarly, Levine (1997) described a study sponsored by the International Foundation of Employee Benefits Plans and the University of Wisconsin-Milwaukee Center for Economic Development which called for the creation of a private intermediary to help pension funds invest in ETIs. This intermediary would represent a cross section of pension funds working together to identify ETI opportunities, solicit proposals from outside investment managers to carry out the ideas, co-invest in the programs, and monitor the investments.

Securitization of products by an intermediary is another way of making an equity investment while overcoming some of the difficulties associated with ETIs. One example is to package individual small business loans that meet the economic
development goals of the fund into a security, converting illiquid individual loans into more liquid securities (Yago et al, 2003). Another example is that of NYCERS, which currently makes investments in fixed-income instruments that offer loans to small business for export finance with resultant small business growth and export expansion (Levine, 1997).

Other common characteristics of successful ETIs include: geographic diversification with reciprocal targeting; risk reduction strategies such as wide diversification of venture capital funds; comparability to benchmarks; clear collateral benefits; and cost reduction strategies such as economies of scale (Calabrese, 1999).

4. CalPERS’ Involvement in Underserved Capital Markets

In 1992, the California Public Employees Retirement System (CalPERS), the largest public pension fund in the United States (current assets of $182 billion US as of Dec. 31, 2004), began to target investment in the State of California as part of its overall investment policies. This long-standing policy of CalPERS’ Board began with their allocation decision to invest $375 million in the development of affordable single-family homes in California as part of their real estate portfolio. The investment was expected to generate 22% returns to the pension fund, provide construction jobs, and fill a capital gap in the market, while increasing the supply of moderately priced homes in the State.

In 1998, CalPERS decided to raise its exposure to venture capital and to help expand the venture capital industry in California. This resulted in a fund-of-funds called California Emerging Ventures, which has now expanded to include other types of private equity investments. Since 1998, two more generations have been added to this fund and over 130 companies have received financing.
Table 2

<table>
<thead>
<tr>
<th>Fund Description</th>
<th>Vintage Year</th>
<th>Capital Committed</th>
<th>Cash In</th>
<th>Cash Out</th>
<th>Cash Out &amp; Remaining Value</th>
<th>Net IRR</th>
<th>Investment Multiple</th>
</tr>
</thead>
<tbody>
<tr>
<td>California Emerging Ventures I, LLC</td>
<td>1999</td>
<td>958,064,006</td>
<td>739,020,813</td>
<td>261,973,793</td>
<td>672,224,324</td>
<td>-4</td>
<td>0.90x</td>
</tr>
<tr>
<td>California Emerging Ventures II, LLC</td>
<td>2000</td>
<td>1,356,275,465</td>
<td>813,738,318</td>
<td>121,986,186</td>
<td>702,510,264</td>
<td>-8.4</td>
<td>0.90x</td>
</tr>
<tr>
<td>California Emerging Ventures III, LLC</td>
<td>2001</td>
<td>466,500,904</td>
<td>93,097,127</td>
<td>4,113,160</td>
<td>70,987,052</td>
<td>-24.8</td>
<td>0.80x</td>
</tr>
</tbody>
</table>

By 2004, CalPERS’ total in-state California investments were valued at approximately $20 billion or 11% of the fund. As of October 31, 2004, 19.5% of the California portfolio was allocated to the AIM Program, 41.25% to real estate, 13% to public equity, and 6.8% to fixed income (see below figure). At this time, the AIM Program had $9.1 billion in commitments that were either headquartered in or had a major presence in California.

Figure 1

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1 CalPERS’ calls its private equity asset class its Alternative Investment Management Program or AIM
It must be remembered that with a GDP of $1.33 trillion, California is the fifth largest economy in the world. As a result CalPERS doesn’t lose portfolio diversification with this geographic focus in their investments. CalPERS policy on risk/return criteria is clear: they do not make concessions on risk-adjusted return, on asset allocation, or on diversification guidelines (Harrigan, 2003).

Within this large in-state portfolio, approximately 2% of the fund is earmarked specifically for ‘Economically Targeted Investment’ (ETI) that includes private equity, real estate and fixed income investments. With full recognition of CalPERS’ fiduciary duty to its plan members, the CalPERS’ Board of Trustees adopted a policy statement in 2000 that clearly laid out the parameters of the ETI program. This document was revised in 2002 and again in 2004. The February 2000, four page document titled Statement of Investment Policy for Economically Targeted Investment Program states “…an Economically Targeted Investment is defined as an investment which has collateral intent to assist in the improvement of both national and regional economies and in the economic well being of the State of California, its localities and residents. Economic stimulation includes job creation, development and savings; business creation; increases or improvement in the stock of affordable housing; and improvement of the infrastructure.”

It goes on to say that “By strengthening the State’s economy and the well being of employers, ETIs help promote the continued maintenance of employer contributions to the System.” However it is clear in the policy statement that the pension fund will not sacrifice returns to meet these objectives. “The system will consider only ETIs which when judged solely on the basis of economic value, would be financially comparable to alternatively available investments. Comparability will be judged on a risk adjusted basis with the System being willing to accept no less in return and incur no additional risk or cost.” Nor will the system take responsibility for the collateral benefits generated from the investment decision.

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2 All quotes in this and the following paragraph are taken from the Statement for Investment Policy for Economically Targeted Investment Program, February 2000, revised June 17th 2002, further revised September 10th 2004.
In 2002, the ETI policy was revised to include a major section (section V.) on “California Emerging Markets Investment Policy”. This policy further targeted CalPERS’ investments into under-served capital markets in the State. “…the objective of this policy is to discover and invest in opportunities that may have been bypassed or not reviewed by traditional, more mainstream sources of investment capital.” Such markets include rural and urban areas undergoing or in need of revitalization where there are assets (e.g. an available labour pool, underutilized infrastructure) conducive to business development. The long-term goal of the policy is 2% of CalPERS’ total portfolio (currently that would be valued at $3.6 billion). This does not imply a mandate to invest in under-served capital markets “but rather should be viewed as an additional set of suggested parameters within which to consider such investment.” These investments include fixed income, private equity and real estate asset classes. Despite the fact that these investments target under-served capital markets, they “…shall be priced at least at market prices and shall be subject to applicable performance measures.” These investments must also receive prudent levels of due diligence, and as part of that process “staff shall consider the current economic condition of the State of California and the prudence of committing assets to under-served areas given that economic condition.”

Two investment programs are key components of CalPERS’ investments in California’s emerging markets. The first is the California Initiative, a $500 million investment program targeting small business and emerging and developing companies in under-served urban and rural California communities. This Initiative falls under the AIM Program, which makes up about 5% of CalPERS’s portfolio. The AIM program explicitly includes a California-oriented component that is designed to take advantage of: “(i) the unique size characteristics of the California economy; (ii) the existence of a “capital gap” for certain business segments within the state; and (iii) the ability to construct a diversified array of investment vehicles that reflects the state’s large number of business entities.” The second program is the California Urban Real Estate or CURE

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program that is part of the real estate asset allocation. This case study focuses on the private equity California Initiative.

5. The California Initiative

5.1 Early Development

The California Initiative moved CalPERS’ long standing targeted in-state private equity investment program toward a more focused set of investments specifically aimed at California’s under-served capital markets (also known as domestic emerging markets). Because of the perceived risks, uncertainty about the market, and lack of knowledge at the Board and staff level, this shift in focus required both a Board-level champion and an external feasibility study in order to raise the comfort level and knowledge about this market for the full CalPERS’ Board and staff. The Board-level champion was Phil Angelides, California State Treasurer, who used his Board position at both CalPERS and CalSTRS (the California State Teachers Retirement System), as well as his role as Treasurer, to advance the ideas associated with investment in under-served capital markets. In May of 2000, he released a thirty-six page report, “The Double Bottom Line: Investing in California’s Emerging Markets” that detailed the advantages of investment in California’s under-served capital market. Drawing from Michael Porter’s work at the Harvard Business School, he outlined the competitive advantage of these communities. He reinforced CalPERS’ and CalSTRS’ decision to enter these markets with corresponding programs at the California State Treasury. Angelides was successful in persuading fellow Board members to look seriously at the opportunities for investment that under-served capital markets present.

While Angelides provided the catalyst for the California Initiative, the CalPERS’ Board and staff needed additional outside resources to assure themselves of the validity of this approach for the pension fund. The California Initiative was to be part of the private equity asset class or AIM program at CalPERS. In 2000, CalPERS’ Board asked staff for a detailed external, expert study of AIM including its targeted commitment to under-
served capital markets. CalPERS’ staff turned to McKinsey Consultants for such a study. This step allowed time for both investment staff and board members to become more familiar with under-served capital markets, and to be reassured that outside experts agreed there were indeed untapped investment opportunities in these markets. The whole CalPERS’ private equity asset class was itself a young portfolio, having been started in 1990 and having an average age of 3.7 years for its investments. Overall this asset class had an asset allocation target of 7%.

**Figure 2**

*Error! Objects cannot be created from editing field codes.*

By June of 2000, the California Initiative was approved by the Board as part of the Economically Targeted Investment Program, opening up the search for suitable investment partners for this program. Its mission statement (adopted May 2001) was: “The California Initiative will invest in traditionally underserved markets primarily, but not exclusively, located in California. The objective is to discover and invest in opportunities that may have been bypassed or not reviewed by other sources of investment capital.” Initially sixty-seven firms responded to CalPERS’ RFP (Request for Proposal) for the California Initiative. CalPERS’ staff and consultants went through a process of rigorous due diligence. By May of 2001, ten private equity firms were selected to partner with CalPERS in this endeavour and a capital commitment of $475 million was allocated to the Initiative. CalPERS uses multiple fund managers in order to cover a range of strategies, such as: corporate partnerships; co-investments; funds of funds; funds that target minority-owned enterprises; etc. (Yago et al., 2003). Although CalPERS structures its investment partnerships in a number of ways, in all cases it looks for the partner vehicle to also invest their own capital in the project, usually at the 50% level.

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4 “Double bottom line” investments are those with both financial and social returns. This is a reference to investments (such as ETIs) that both achieve acceptable risk-adjusted rates of return and achieve some type of social collateral benefit as well; for instance, creating jobs or affordable housing in a low-income area.

5 From California Initiative Program: Investing in California’s Underserved Markets, November 2004

6 American River Ventures; Bank of America; DFJ Frontier; Nogales Investors; Garage Technology Ventures; Green Equity Investors; Opportunity Capital; Provender Capital; Pacific Community Ventures; and Yucaipa Companies
The largest investment was and still is with Yucaipa Corporate Initiatives Fund, with an initial capital commitment of $200 million. The second largest commitment was to Bank of America Fund of Funds at $100 million. Three funds were already existing GPs (general partners) of CalPERS, while several others were new, innovative small funds with whom CalPERS was prepared to partner. Most of these investments were small by CalPERS’ standards, between $10 and $25 million. Given that the due diligence required is the same as that for a large investment it was important that the AIM investment staff shared the Boards commitment to the program. The investment funds themselves covered the spectrum of private equity from early stage seed funds to corporate funds. As of November 2004, $230 million of the $475 million committed has now been invested, in 56 companies.
Not only were the investment partners providing different structures and private equity investment styles, they were also geographically dispersed throughout California, with 22 companies in Northern California and 15 in Southern California. In all cases CalPERS expectation is that the partner vehicles work closely with community and economic development groups as well as city, county, state and federal agencies.

Key criteria that determine investment decisions in under-served capital markets by these investment funds are:

1) That the company is located in a region with limited access to investment capital.
2) That there diversification of company management (either women or ethnic minority).
3) That the company employs workers from low and moderate income areas?

5.2 Impacts

The California Initiative is in the early stages of its growth. Much of the capital allocation remains to be invested. The impact on California’s under-served capital
market is already noticeable. The $475 million of CalPERS’ capital allocation has leveraged commitments for a further $725 million from other investors. The role of CalPERS as the lead (or first) investor is key. In the November 2004 CalPERS’ Board report on the California Initiative it estimated that to date over 3,000 jobs have been created as a result of this initiative. Because most of the investments have not been fully realized (i.e. CalPERS’ has not exited from the investments), they are at the early stages of the J-Curve and performance numbers on these investments are not yet meaningful, with a net internal rate of return (IRR) of -22.4% on the California Initiative as of June 30th 2004. Over time as these investments mature it would be expected that they would at least match the total AIM portfolio return (currently at a net IRR of 9.8% since inception in 1990). CalPERS is aiming for returns of up to 15/20%. In other words, since the program is less than 5 years old (weighted average age) it has not yet moved into the profitable part of the curve.

Figure 5
Error! Objects cannot be created from editing field codes.

To date the funds collectively have invested $230 million in fifty-six businesses of which thirty-seven are in California, though all the investee firms meet one or more of the under-served markets criteria (see above). Of the thirty-seven California investee companies, 70% had limited access to capital, half had women or ethnic minority ownership or management and twenty-two percent employ a low and moderate income workforce.

Table 3

7 Low and moderate income (LMI) areas are defined as 50% and 80% of median income respectively.
8 In the early years, private equity funds will show low or negative returns due to the management fees & expenses and the fact that investments will not yet have been exited. However, investment gains are achieved in later years when the companies have matured and returns can be realized. This is known as the J-Curve effect.
<table>
<thead>
<tr>
<th>% Impact on Underserved Markets by:</th>
<th>Criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Limited Access to Capital (as % of $ invested)</td>
</tr>
<tr>
<td>The 37 Californian Companies</td>
<td>70</td>
</tr>
<tr>
<td>The total 56 Companies</td>
<td>63</td>
</tr>
</tbody>
</table>

Many different types of investments are represented within this portfolio. For instance, the Bank of America fund is actually a fund of funds which is diversified across a wide number of industries. On the other hand, the Pacific Community Ventures Investment Partners fund directly invests in businesses such as Evergreen Lodge, a San Francisco lodging business that also has the social goal of helping at-risk Bay Area youth to develop stable careers and lives. Another investment that Pacific Community Ventures has made is that of Beacon Fire & Safety, which provides sales and service of fire safety equipment while employing low-income workers from at least six different communities in California. Provender Capital has provided financing for Carver Bancorp, Inc., the largest African-American operated savings bank in the United States. Yucaipa has invested in a restaurant chain called Picadilly Cafeterias, Inc, which was facing bankruptcy, thus saving jobs. This business’ workforce is made up of 65% minorities and 74% of the restaurants are located in underserved communities. Thus, the investments have varying structures and represent a wide diversity of industries.

**Figure 6**

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This initiative has also experienced a number of challenges thus far. Some of the current issues the CalPERS’ Board and staff are facing include:

1) These last few years have been a difficult fund raising period and not all the allocated capital has been deployed, resulting in some of California Initiative investment vehicles not reaching ideal size.

2) The Bank of America Fund of Funds has not found as many suitable California opportunities that clear their hurdle, resulting in less capital allocation in the State.

3) That not every fund has invested a majority of its capital in California.
6. Best Practice Results

6.1. Preliminary Best Practice Findings

It is important to note that the role of pension funds should not be to create the market that they invest in. They simply provide liquidity to the market and then exit the opportunities after the first stage of risk-taking. Investing in targeted private equity should be a profitable endeavour, following best practices drawn from the California Initiative and other pension funds’ experience.

The most important best practice result is that of measuring success first in terms of the risk-adjusted rate of return, and only subsequently on other targets. This allows the fund managers to be sure of meeting their fiduciary responsibilities. This is also the best way to benefit the community, since theory suggests that, by filling capital gaps, the investor should both receive excess returns and support economic development. If the investor does not receive an appropriate return, it is probable that they are not filling a true capital gap (i.e. a gap that an efficient market would have funded), but are instead investing in projects that an efficient market would have left unfunded. Calabrese (1999) lists the comparability of fund returns to an appropriate benchmark as one of the common characteristics of leading successful alternative investment programs. CalPERS does not make concessions on risk/return criteria (Harrigan, 2003).

Another best practice is to use geographic rather than social targeting, and to set broad targets. This allows the fund to focus on diversification and return, by allowing for some flexibility in the way that it meets social goals. For instance, CalPERS believes in picking proven fund managers and investment vehicles and allowing these top-quartile vehicles to do their job within some broad guidelines. It is important to avoid having too little in-house oversight -- but it is equally important to avoid having too much (Calabrese, 1999). CalPERS does not distort established asset allocation and geographic diversification guidelines in order to achieve their social goals (Harrigan, 2003). Having geographic targets, such as focussing on inner cities (as suggested by Porter) or within
any particular underserved capital market, makes it easier for both social goals and financial goals to be met.

There are also best practices in terms of the way pension funds structure their targeted investments. One best practice that many successful alternative investment programs use is that of geographical diversification through reciprocal targeting (Calabrese, 1999). This allows pension funds to invest a sum of money into a diversified portfolio with the understanding that the same amount of money will be invested, from the broad portfolio, within their geographical area. Levine (1997) suggests that pension funds work together to create a development foundation which would allow for diversification of investments and spreading of risk, but still allow some control over the investments by the individual pension funds. Commingled funds with professional management allow for pooling of capital by the pension funds and can help reduce costs and increase economies of scale, while at the same time allowing for direction by professional hired management (Blakely 1985, Calabrese, 1999). Partnering with private investors is a best practice because it allows fiduciary concerns to be addressed by confirming that risk-return goals, diversification, and due diligence are being appropriately dealt with (Calabrese, 1999). The next sections look at some cases which illustrate some of these best practices, starting with the California Initiative, and finishing with some other examples of targeted private equity funds.

6.2 The California Initiative as a Best Practice Case

CalPERS undertook the California Initiative as an intentional investment strategy that achieves both a market risk-adjusted rate of return and invests in California’s underserved capital markets. CalPERS hopes to gain strong performance from its long-term investments by being early entrants into these markets (on this point see Michael Porter and the “Competitive Advantage of Inner Cities”). Additionally the fund hopes to strengthen the economic health of California and by extension to underpin the ability of employers to maintain their contributions to the pension plan. Finally, CalPERS believes that economically vibrant and healthy communities indirectly benefit the pension plan, its members and retirees.
The California Initiative is a new program, and the investment portfolio is still too young for the return results to be meaningful. Currently at –22%, the returns are indicative of the J-curve effect, where early years reflect management fee expenses and investments have not yet been exited. CalPERS’ total investment in the California Initiative is $500 million, representing 0.3% of CalPERS’ total portfolio. CalPERS’ investment officers bring a long-term investment horizon to this asset class and feel strongly that Board level sensitivity to these markets allows CalPERS first-mover advantage, entering the market ahead of other investors and as a result capturing significant returns. This has certainly been the case with CalPERS’ other targeted program, the California Urban Real Estate Program (CURE), where performance in 2004 of the non-core real estate portfolio of which CURE is a significant component had an annual return of 20.9% (far superior to that of the core real estate portfolio).

While financial concerns are the primary drivers of any investment decision-making, CalPERS’ targeted investments have delivered significant collateral benefits that strengthen the economic underpinnings of the State. These collateral benefits are measured in greater employment, opportunities for women and minority owned businesses, increased affordable housing, and stronger and healthier communities.

As a public employee pension plan, CalPERS is aware of the political climate in which it operates. When asked, almost all Board and staff of the fund say that the California Initiative will be judged by the financial returns it generates over time. In order to ensure out-performance CalPERS is extremely careful in its investment manager selection process and looks for managers with known track records of success. This means it is hard for new investment vehicles to receive CalPERS’ funding. The biggest obstacle facing the fund will be the patience required for long term results to be achieved. As several pension fund officials have stated, there is limited reward for success in non-traditional investment decisions, while failure is heavily punished (primarily through negative media attention). This is particularly challenging when CalPERS is required by
law to post publicly its quarterly performance results for all private equity investment managers.

CalPERS has chosen a deliberate targeted investment strategy focused on California’s under-served capital markets. It is still too soon to see whether the California Initiative will be a ‘best practice’ case in terms of its financial contribution to the pension plan, which is the key factor. This remains to be seen in years to come. However, while still a young investment program, the California Initiative does have the potential for long term returns benefiting the pension plan, its members and the larger community.

7. Testing the Impact of Geographic Targeting
7.1 The sample
We test the impact of geographic targeting on investment portfolios using MacDonald and Associates data on Canadian private equity investments exited between 1999 and 2005. We compare exited deals where at least one of the investment partners had a stated geographic target against investments with no geographic targeting.

We used data on private equity investments exited between 1999 and 2005. These criteria left us with two hundred and ninety deals to examine. We were able to identify deals in which at least one of the investment partners had a stated geographic target. This allowed a ‘targeted’ variable to be added to the sample to differentiate between these deals and deals in which no geographic targeting was used. Sixty of the deals had at least one investment partner with targeting criteria and two hundred and thirty did not. Thirteen of the deals were buyouts, sixteen were mezzanine financing deals, and the remaining two-hundred sixty-one were venture capital deals.

There were seventy-eight IPO exits in the sample, eight firms that went out of business, and the remaining two-hundred and four ended in mergers or acquisitions. The number of investors participating in each deal varied, ranging from one investor to, in two cases, eleven. The firms in which funds were invested were located throughout Canada. Within the sample there were representatives from eight provinces, as follows:
<table>
<thead>
<tr>
<th>Province</th>
<th>Number of Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>British Columbia</td>
<td>40</td>
</tr>
<tr>
<td>Alberta</td>
<td>21</td>
</tr>
<tr>
<td>Saskatchewan</td>
<td>1</td>
</tr>
<tr>
<td>Manitoba</td>
<td>1</td>
</tr>
<tr>
<td>Ontario</td>
<td>157</td>
</tr>
<tr>
<td>Quebec</td>
<td>64</td>
</tr>
<tr>
<td>New Brunswick</td>
<td>1</td>
</tr>
<tr>
<td>Nova Scotia</td>
<td>5</td>
</tr>
</tbody>
</table>

7.2. Methodology

The goal of the analysis was to determine if whether or not a deal is a targeted investment will predicts its subsequent success or lack thereof. Thus, the analysis was intended to look at whether targeted or un-targeted investments were more likely to be successful on a number of different criteria. The initial step in the analysis was to determine whether or not the two sub-samples (targeted and un-targeted investments) were well-matched in terms of other possible determinants of success. Factors such as age, sector, and size of firms are known to affect access to capital ((Madill et al., 2005a; Haines et al., 1999). Thus, t-tests were performed in order to test the comparability of the samples on these predictors.

Secondly, it was necessary to define what was meant by ‘success’. For the purpose of this analysis, success was defined in terms of the amount of time between the initial investment and the exit and in terms of the type of exit. Rate of return will be examined in the next paper in this series.

A shorter time to exit, and thus a quicker return on investment, is considered more desirable in this study. Venture capital firms obtaining shorter times to exit are considered to be more successful than those that did not. Often, venture capital
investments become the ‘living dead’: an investment that has not reached the level of growth or profitability required to produce attractive returns, but which is still viable and is not losing money (Ruhnka et al., 1992). These investments never generate the desired returns for the investor, because they must be held for so long. Returns achieved more quickly are better. Thus, a successful deal is one which can be exited within a reasonable time frame. If targeted and un-targeted investments differ greatly in their average time to exit, then there is a probability that one type is more successful at avoiding the ‘living dead’ and at turning over deals more quickly.

With regards to type of exit, it is generally considered that IPOs are the more profitable exit types for venture capital investments (Davis, 2003). This type of exit usually boasts higher returns than acquisitions, for instance, and does not generally result in a loss for the venture capital investors. Balboa & Marti (2004) explain that the ability for firms to participate in an accessible IPO market is essential for the existence of a private equity or venture capital market. Similarly, Bygrave & Timmons (1992) state that the venture capital process would not be feasible without IPOs. Unfortunately, the Canadian IPO market is more restrictive than the American IPO market (Davis, 2003). For this reason, it is especially important to note any differences between targeted and un-targeted investments in terms of the type of exit they are able to achieve. Three types of exits were listed in the M&A database: IPO; Merger & Acquisition; and Out of Business. Although the following data is old, it is still interesting to note that in a study of twenty-six funds exiting over four hundred investments between 1970-1982, Bygrave & Timmons (1992) found that only IPOs made more than one times investment (at 1.95 times). The next highest was acquisitions, with gains of only 0.4 times. Thus, investments exiting via IPO were considered to be more successful in this study.

In order to determine which of the sub-samples was more successful in terms of these two factors, a number of tests could be performed. First, simple t-tests were performed to provide a comparison of means for targeted and un-targeted investments on the above criteria of success. Secondly, regressions were performed including factors such as size, sector, age, and whether the firm was targeted to see whether success was predicted by
any of these factors. Two separate regressions were run: one with the dependent variable ‘time to exit’ as the success factor being predicted; and one with ‘type of exit’ as the dependent variable.

7.3. Results

Comparison of the sub-samples

The first step, as described above, was to perform t-tests to determine whether or not the two sub-samples were well-matched. The following table shows statistics for the age of the firm at the time of first investment and the sector (industry division) in which these firms operate.

<table>
<thead>
<tr>
<th>Age of Firm at first investment</th>
<th>N</th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>Std. Error Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
<td>146</td>
<td>6.84</td>
<td>11.691</td>
<td>.968</td>
</tr>
<tr>
<td>Yes</td>
<td>43</td>
<td>8.86</td>
<td>22.412</td>
<td>3.418</td>
</tr>
<tr>
<td>IndustryDivision</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No</td>
<td>230</td>
<td>4.35</td>
<td>4.477</td>
<td>.295</td>
</tr>
<tr>
<td>Yes</td>
<td>60</td>
<td>3.50</td>
<td>4.328</td>
<td>.559</td>
</tr>
</tbody>
</table>

The following shows the t-tests that were performed for age and sector.

<table>
<thead>
<tr>
<th>Age of Firm at first investment</th>
<th>Levene's Test for Equality of Variances</th>
<th>t-test for Equality of Means</th>
<th>95% Confidence Interval of the Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equal variances assumed</td>
<td>F</td>
<td>5.405</td>
<td>.021</td>
</tr>
<tr>
<td>Equal variances not assumed</td>
<td>t</td>
<td>.570</td>
<td>48.911</td>
</tr>
<tr>
<td>IndustryDivision</td>
<td>Levene's Test for Equality of Variances</td>
<td>t-test for Equality of Means</td>
<td>95% Confidence Interval of the Difference</td>
</tr>
<tr>
<td>Equal variances assumed</td>
<td>F</td>
<td>1.029</td>
<td>.311</td>
</tr>
<tr>
<td>Equal variances not assumed</td>
<td>t</td>
<td>1.349</td>
<td>94.646</td>
</tr>
</tbody>
</table>

There did not appear to be any significant differences between the two samples with respect to the age of the individual firms that received an investment, nor in terms of the industries in which they operate.
Ordinarily, a size variable should also be tested. However, the database to which the researchers had access did not provide any information on the size of the firms, either in terms of annual sales or number of employees. The only variable which could provide any indication as to size is the market capitalization factor at IPO for those firms that exited by this method. This is probably not an ideal measure because it is related to rate of return as well as to type of exit. However, a set of t-tests was performed for the IPO firms only in order to determine if there were any differences. The t-tests showed no significant differences between the sub-sample of targeted investments exiting via IPOs and un-targeted investments exiting via IPOs with respect to the age of the firm or the market capitalization.

It appears that the sub-samples of targeted and un-targeted firms are well matched with respect to traditional predictors of financing like size, sector, and age. There is no significant difference between sector or age for the sample as a whole and there is also no significant difference between the two groups with respect to market capitalization at IPO.

7.4. Tests of Success Factors
Subsequent to ensuring that the samples were well-matched, t-tests were performed in order to compare the means of the various success factors for targeted and un-targeted firms. Those for type of exit and time between investment and exit are shown below.

<table>
<thead>
<tr>
<th>Group Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exit Type</td>
</tr>
<tr>
<td>N</td>
</tr>
<tr>
<td>--</td>
</tr>
<tr>
<td>targeted</td>
</tr>
<tr>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
</tr>
<tr>
<td>Yes</td>
</tr>
<tr>
<td>Time (Years) Between Investment and Exit</td>
</tr>
<tr>
<td>N</td>
</tr>
<tr>
<td>--</td>
</tr>
<tr>
<td>targeted</td>
</tr>
<tr>
<td>Yes</td>
</tr>
</tbody>
</table>
Independent Samples Test

<table>
<thead>
<tr>
<th>ExitType</th>
<th>F</th>
<th>Sig.</th>
<th>t</th>
<th>df</th>
<th>Sig. (2-tailed)</th>
<th>Mean Difference</th>
<th>Std. Error Difference</th>
<th>95% Confidence Interval of the Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equal variances assumed</td>
<td>.305</td>
<td>.581</td>
<td>-.338</td>
<td>288</td>
<td>.736</td>
<td>-.043</td>
<td>.129</td>
<td>-.297 to .210</td>
</tr>
<tr>
<td>Equal variances not assumed</td>
<td>-.333</td>
<td>90.492</td>
<td>.740</td>
<td>-.043</td>
<td>.131</td>
<td>-.297</td>
<td>.210</td>
<td></td>
</tr>
<tr>
<td>Time (Years) Between Investment and Exit</td>
<td>4.524</td>
<td>.034</td>
<td>-.836</td>
<td>288</td>
<td>.404</td>
<td>-.319</td>
<td>.381</td>
<td>-1.069 to .432</td>
</tr>
<tr>
<td>Equal variances assumed</td>
<td>-948</td>
<td>111.215</td>
<td>.345</td>
<td>-.319</td>
<td>.336</td>
<td>-985</td>
<td>.348</td>
<td></td>
</tr>
<tr>
<td>Equal variances not assumed</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

No significant differences were revealed by the t-tests. However, these tests look at the aggregate results. There were three types of financing listed in the sample. These were buyout, mezzanine, and venture capital financing. The following table shows the breakdown of investments by financing type.

**Financing Type**

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valid</td>
<td>Buyout</td>
<td>13</td>
<td>4.5</td>
<td>4.5</td>
</tr>
<tr>
<td></td>
<td>Mezzanine</td>
<td>16</td>
<td>5.5</td>
<td>10.0</td>
</tr>
<tr>
<td></td>
<td>Venture Capital</td>
<td>261</td>
<td>90.0</td>
<td>100.0</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>290</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Most of the deals were venture capital deals, but sixteen were mezzanine financing and thirteen were buyouts. It is possible that there might have been differences by type of financing; this would not show up in the aggregate results, especially since venture capital dominates the sample. For instance, perhaps targeting produces different results when the investment is a venture capital investment as opposed to a mezzanine financing investment. For this reason, these success factors were also examined within each of the types of financing individually. The t-tests for buyouts are below.
There are no significant differences with respect to the success factors of exit type and time to exit. Similarly, the results of the mezzanine financing group, below, also fail to show any significant differences with respect to these success factors.

Mezzanine:
### Group Statistics

<table>
<thead>
<tr>
<th>Exit Type</th>
<th>targeted</th>
<th>N</th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>Std. Error</th>
<th>Mean</th>
<th>Std. Error</th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
<td>13</td>
<td>2.08</td>
<td>1.038</td>
<td>.288</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>3</td>
<td>1.67</td>
<td>1.155</td>
<td>.667</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Age of Firm at first investment</td>
<td>No</td>
<td>8</td>
<td>21.88</td>
<td>25.267</td>
<td>8.933</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>2</td>
<td>53.50</td>
<td>62.933</td>
<td>44.500</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Age of firm at Exit</td>
<td>No</td>
<td>8</td>
<td>23.50</td>
<td>25.151</td>
<td>8.892</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>2</td>
<td>56.00</td>
<td>59.397</td>
<td>42.000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Time (Years) Between Investment and Exit</td>
<td>No</td>
<td>13</td>
<td>1.62</td>
<td>2.599</td>
<td>.721</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>3</td>
<td>4.33</td>
<td>4.041</td>
<td>2.333</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Independent Samples Test

<table>
<thead>
<tr>
<th></th>
<th>Levene’s Test for Equality of Variances</th>
<th>t-test for Equality of Means</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>F</td>
<td>Sig.</td>
</tr>
<tr>
<td>Exit Type</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equal variances assumed</td>
<td>1.013</td>
<td>.331</td>
</tr>
<tr>
<td>Equal variances not assumed</td>
<td>5.65</td>
<td>2.799</td>
</tr>
<tr>
<td>Equal variances not assumed</td>
<td>- .757</td>
<td>1.091</td>
</tr>
<tr>
<td>Age of firm at Exit</td>
<td>3.737</td>
<td>.089</td>
</tr>
<tr>
<td>Equal variances assumed</td>
<td>- .757</td>
<td>1.091</td>
</tr>
<tr>
<td>Equal variances not assumed</td>
<td>- .113</td>
<td>2.396</td>
</tr>
<tr>
<td>Time (Years) Between Investment and Exit</td>
<td>.784</td>
<td>.397</td>
</tr>
<tr>
<td>Equal variances assumed</td>
<td>-1.113</td>
<td>2.396</td>
</tr>
</tbody>
</table>

Lastly, the venture capital deals, which make up the bulk of the investments were examined.
It does appear that targeted venture capital deals have used firms that are significantly younger than non-targeted firms. However, there are no significant differences between the targeted and un-targeted investments with respect to the exit type or the time between investment and exit.

These t-tests do not seem to indicate that un-targeted investments are any more or less successful than targeted investments on the criteria of time between investment and exit and the type of exit. This remains true for each sub-type of financing deal (venture capital, mezzanine, and buyout). This result implies that targeted firms are no different
from un-targeted firms in terms of the time it takes them to exit a deal or the type of exit that they will ultimately achieve.

7.5 Implications
There are no significant differences between targeted and un-targeted investments in terms of sector, age or market capitalization (a proxy for size). This means that the samples were fairly well matched for comparison. When this comparison was completed, it was determined that there are no differences in ‘success’ between targeted and un-targeted firms, at least in terms of time to exit, and type of exit. Neither targeting nor failing to target geographically was found to be a predictor of success.

So far in this study, there does not seem to be a difference between targeted and untargeted firms in terms of either the traditional predictors of financing (age, size and sector), or the ‘success’ factors selected in this study. This implies that there may not be a trade-off between ‘doing good and doing well’. An important caveat to the above implications is that returns has not yet been compared for these two groups. However, as noted above, deals exiting sooner, and deals exiting via IPO are both more likely to have greater returns. We find no difference between targeted and untargeted portfolios in terms of early exits or IPOs.

8. Implications for Canadian Pension Funds and Public Policy
The California Initiative case and other best practice cases discussed above are too young for their final financial success or failure to be determined. However, based on theoretical evidence as well as the initial evidence from these funds, targeted private equity investments could be beneficial for Canadian pension funds. There is an opportunity for pension funds to fill capital gaps in the market, especially given the broad nature of documented gaps such as the capital gap between two and five million dollars. The existence of such capital gaps means that the market for private equity is not efficient, and that there is room for pension funds to make attractive rates of return while promoting economic development in their regions.
However, there are many obstacles in place at the current time. Canadian pension funds have shown themselves to be less willing to invest in private equity than their American counterparts. For instance, one estimate suggests that, in the United States, pension funds commit five percent to eight percent of their assets to venture capital, while the rate in Canada is closer to one percent (Davis, 2003).

Why are Canadian pension funds less likely to invest in private equity than American funds? One reason for this is that Canadian pension funds tend to have smaller assets, increasing the likelihood of ‘structural barriers’ to private equity investments (Chemla, 2004). This, however, could be addressed through commingled or pooled funds and other best practices described above if fund managers were aware of these vehicles. In addition, the size and characteristics of the Canadian financial market play a role. The Canadian private equity and venture capital markets may not be as developed as the American markets (Chemla, 2004) and many Canadian funds are still too new or young to have a track record (Industry Canada, 2004). The IPO market in Canada is also less active than that in the United States, making the liquidity problem even greater (Chemla, 2004).

Further, there are few examples of ETIs in Canada, and where they do exist, there is very little research with respect to their rates of return; what research does exist is mostly anecdotal (Quarter et al., 2001). This adds to the unwillingness of pension funds to invest, since they lack information on which to base informed decisions.

It is important to look at and address the reasons why more pension funds are not involved in targeted investment programs. There is a strong need to educate trustees and
other gatekeepers (Calabrese, 1999). Yago (2003) suggests that more information needs to be made available so that pension funds managers will be better able to judge the risks involved. One possibility would be to establish an information clearinghouse (Calabrese, 1999). This is a potential role for public policy. Encouraging pension funds to fill capital gaps in the market would improve the economy by making the market more efficient and increasing economic development, and at the same time would be a profitable endeavour for pension funds and their beneficiaries.

There is a role for public policy in overcoming the barriers that Canadian pension funds are currently facing with respect to investment in private equity in general, and targeted investing in particular. As the Finding the Key Report, put forward by Industry Canada (2004) suggests, funds of funds, gatekeepers and other tactics can help pension funds to overcome barriers to private equity investing. However, in order for this to occur, education is paramount. It is important to continue to learn from those pension funds that are currently involved in targeted investing, such as CalPERS, and to take advantage of this knowledge of best practices to guide pension fund investing in Canada (Davis, 2003).

It is clear that, while evidence supports the idea that pension funds can profit from targeted investing, further work remains to be done. It is important to continue studying the experiences of pension funds in the United States and elsewhere that have already pioneered successful efforts in this area. Canadian funds can learn from mistakes that were made and profit from best practices. In addition, as time passes more information will become available about the financial returns of these endeavours. This will make it easier to assess the risk-return universe that is available within this type of investment and facilitate forecasting.

There is a continued role for public policy to help Canadian pension funds overcome the barriers that they face with respect to targeted private equity investing. Education and availability of information are areas which should be addressed as soon as possible. Targeting investments to underserved capital markets could be beneficial to Canadian pension funds, as well as to the economic development of the country as a whole.
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