Verus™

Building effective private market portfolios

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Executive summary

Institutional sponsors often invest in private asset classes to boost the return profile of their overall plan portfolios. Yet, many fall short of achieving the desired returns. The historical data we reviewed reveals a large return dispersion between top- and bottom-quartile fund managers and top- and bottom-quartile institutional private market portfolios, revealing the challenges that investors face when building a private markets program. Drawing on our experience over the last 20 years, we highlight the key considerations for any investor seeking to build a private markets portfolio, (i) emphasize manager selection, (ii) commit to private market funds directly, (iii) avoid over diversifying your portfolio, and (iv) manage the j-curve impact.

Introduction

Private equity has outperformed the public markets by a substantial margin, net of fees, as illustrated in the table below. Over the last 20 years, the pooled return of U.S., European, and Global private equity funds outperformed their corresponding public markets universes by 4.9%, 9.4%, and 7.3% a year, respectively.

THOMPSON REUTERS C|A PRIVATE EQUITY UNIVERSE – 6/30/18

Pooled Returns vs. Public Markets Equivalent	1 Year	3 Year	5 Year	10 Year	20 Year
U.S. Pooled Returns					
U.S. All Private Equity Direct*	18.5	11.9	15.2	11.2	12.9
Russell 3000 Index	14.9	11.4	13.6	10.7	8.0
Europe Pooled Returns					
Europe All Private Equity Direct*	19.4	16.2	13.4	6.8	14.2
MSCI Europe Index	5.4	3.7	6.6	3.3	4.8
Global Pooled Returns					
Global All Private Equity Direct**	18.0	12.1	14.4	10.1	12.7
MSCI ACWI Index***	10.7	8.2	9.4	5.8	5.4

** All PE Direct excludes Natural Resources, Real Estate, Infrastructure, Fund of Funds, and Secondaries.*

*** Global Funds invest across the globe, without any targeted regions for investment.*

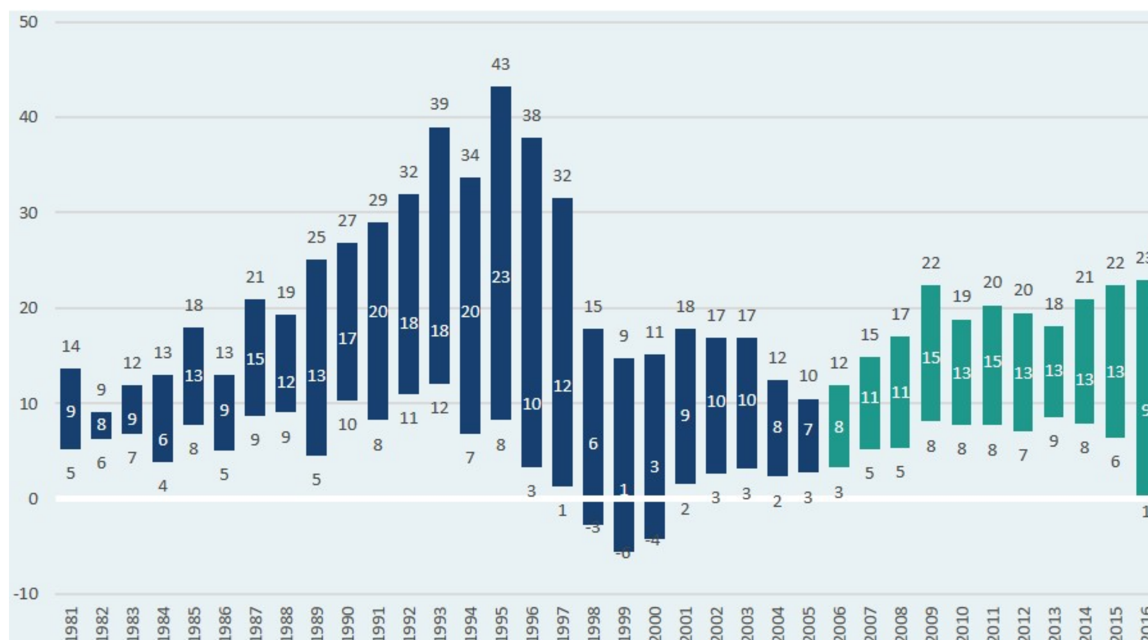
**** Due to limited historic data, return is time-weighted.*

Despite the potential upside of private markets investments, there are many ways to underperform expectations. To achieve the enhanced returns potential of private asset classes, investors must adopt some key best practices on portfolio construction. This paper will discuss essential factors that impact portfolio results and provide some best practices that we use to increase the chances in delivering on the implied premium associated with the asset class. These practices follow agreement on a policy statement delineating the role and objectives of the asset class, as well as guidelines on implementation. Policy statements not only clarify expectations and approach at the outset, but also serve as an important reference point to guide ongoing evaluations of, and future considerations with regard to changes to, the portfolio in a deliberate, consensus driven fashion.

Emphasize manager selection

The hardest task for investors, and the one that will have the largest impact on portfolio performance, is manager selection. The wild variation in performance between individual managers investing in the same market environment is what makes this asset class difficult to execute well. Private equity universe data provided in the graph below shows the gap in performance between top performing funds and bottom performers by vintage year.

THOMPSON REUTERS C|A U.S. All PRIVATE EQUITY UNIVERSE RETURN
TOP- TO BOTTOM-QUARTILE DISPERSION BY VINTAGE YEAR (1981-2016) – 6/30/18



— ***Mature Funds average dispersion: 15.8%***

— ***Active funds average dispersion: 13.6%***

The dispersion varies by sub-asset class and will expand and tighten from year-to-year, but the message stays consistent: top-quartile funds provide substantial outperformance relative to bottom-quartile funds. More importantly, as poor performance in private markets can often detract significant value, often well below public benchmarks, it is of paramount importance for investors to invest in the best funds in order to realize a return premium above the public markets.

What makes the investment decision more complicated is that investors have to commit to funds that have no underlying investments at the time those funds are raised. Thus, the investment process centers on the selection of managers capable of making compelling investments and generating attractive returns, all in the future.

To narrow in on the most capable fund managers, institutional investors often rely on evaluating past performance; assuming that if a manager has generated attractive returns in prior funds, their outperformance will persist. Early academic studies found some evidence of such persistence, but more recent studies have called into question the perception that top performing managers will stay top performing in subsequent funds, at least in areas like private equity buyouts. Additionally, those managers who have exhibited great skill also tend to be difficult to access for new investors. Building a portfolio of top-quartile managers requires sourcing capabilities, experience in due diligence, and good judgement. Sourcing

good GPs is a labor-intensive process of proactively establishing relationships with managers, marketing firms/placement agents, and other LPs. Due diligence often takes 2-3 months of work on each fund and requires an understanding of how a strategy has generated value in prior investments and how repeatable that performance might be in the current market environment.

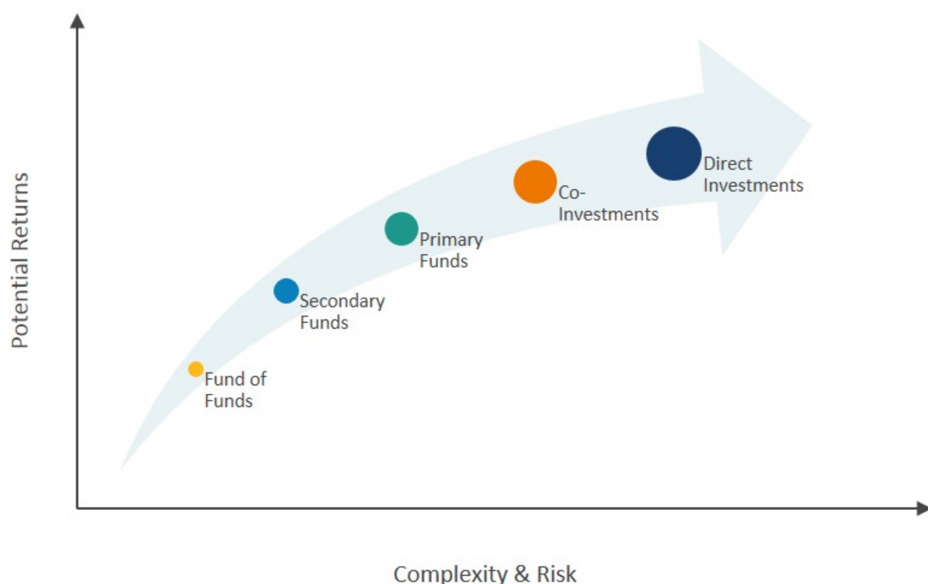
As an example, if research uncovers that a key driver of a manager's past performance was due to multiple expansion (i.e. the valuation multiple the manager paid for a business was below the exit multiple), holding other factors constant, that strategy may not be repeatable if the current environment is one in which transaction multiples are at historic highs. So much of what we as investors use as a basis for decision making requires judgement which is informed by data, as well as experience, both good and bad. Our due diligence focuses on identifying high potential, repeatable skill; and understanding the key risks, both those that are mitigated and others that may not be in consideration of long-term illiquid fund commitment.

Private equity's enhanced returns, relative to public markets, is a function of active management. The ability to buy businesses at an attractive value, provide growth capital and/or participate in the creation of early stage companies before public markets are viable, and operate companies more efficiently by adopting incentives that better align both the operating and investment managers all contribute to what we believe are an active management premium. As private markets become more crowded with capital and managers, some of the inefficiencies, namely the ability to buy companies at a discount, contract. But many others, for example the skill to enhance the operating performance of a business, should endure as industry insight and the levers to improve the growth and efficiency of companies are ever evolving and endless.

Commit to funds directly

There are several ways for investors to access private market strategies. These include, fund-of-funds, secondary funds, primary funds, co-investments and direct investments/ direct deals.

Generally speaking, returns, risk and implementation complexity increase as you move from fund-of-funds to investing in direct investments. What determines the right approach for most institutions comes down to resources and available capital. The same inter-quartile spread that we find in private market funds relative to public market strategies will only grow wider as you shift up the complexity spectrum to financing direct private investments.



Return data from Thompson Reuters C|A on the private equity universe across primary, secondary and fund-of-fund strategies highlights the return gaps between implementation approaches.

THOMPSON REUTERS C|A PRIVATE EQUITY UNIVERSE – 6/30/18

Pooled Returns by Implementation Approach	1 Year	3 Year	5 Year	10 Year	20 Year
U.S. Pooled Returns					
U.S. All Private Equity Direct*	18.5	11.9	15.2	11.2	12.9
U.S. Fund of Funds	15.3	8.1	13.2	9.1	9.3
U.S. Secondary Funds	15.2	8.6	11.4	9.8	11.8
Europe Pooled Returns					
Europe All Private Equity Direct*	19.4	16.2	13.4	6.8	14.2
Europe Fund of Funds	14.4	10.8	10.3	4.8	8.6
Europe Secondary Funds	14.9	9.3	12.7	8.4	12.7
Global Pooled Returns					
Global All Private Equity Direct**	18.0	12.1	14.4	10.1	12.7
Global Fund of Funds **	15.9	9.0	12.8	8.4	9.2
Global Secondary Funds **	15.9	9.8	12.3	9.8	12.3

** All PE Direct excludes Natural Resources, Real Estate, Infrastructure, Fund of Funds, and Secondaries.*

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Fund-of-funds have underperformed both secondary and primary fund universes by 2.5% and 3.6% annually, respectively over the trailing 20-year period for U.S. focused funds. These results are directionally consistent across European and Global fund universes, as well. We note that certain costs to implementing a primary fund program are not captured in this data.

While certain specialty and differentiated fund-of-funds, for example those focused on hard-to-access geographies, may play an additive role in a portfolio, for plans large enough to bear the cost of hiring staff or outsourcing portfolio implementation, a direct private markets portfolio (i.e. primary funds) constituting the bulk of core holdings has the potential for meaningful outperformance. As private markets become more efficient, institutions seeking alpha will have to be increasingly mindful of fees that can deplete excess returns.

Plan to diversify, but not overly so

While careful manager selection is of paramount importance, diversifying by sub-asset class, vintage year, industry, geography and manager teams/organizations can further reduce undue risks. We don't believe that investors can consistently forecast market cycles several years into the future, and even if one believed otherwise, illiquid fund structures that invest and exit such investment over multiple years would not be an efficient way to express market views. Our approach to building a portfolio involves consistent allocations each year to high confidence managers that will over time diversify risks among the factors listed above. Beyond ensuring we are diversified, we also consider market cycles, valuations, manager styles, and other factors to help manage risk.

Following a pacing model is a good way to enforce discipline in implementing a private markets program. Pacing studies serve several functions, one of which is to provide a blueprint for investors to follow to reach their desired target allocation to private asset classes. A pacing study will also provide a projected cash flow budget and help in portfolio design and diversification by sub-asset class and vintage year.

Pacing studies at their basic are cash flow projection models that make a series of assumptions around the "pace" of your capital contributions and distributions and the growth rate of investments. A good model will have unique assumptions within each underlying strategy. For example, a venture capital strategy will typically draw down capital slower, make distributions much later in the fund life and should have a higher return expectation than a buyout fund's assumptions. Modeling sub-asset classes will improve the reliability of the model and provide a better blueprint to follow for investors.

As commitments are modeled, investors should be consciously diversifying among investment sub-asset classes and geographies as well as, spacing out commitments to achieve vintage year diversification. A rule-of-thumb within private equity is to have a 60/25/15 portfolio.

- 60% in Buyouts,
- 25% in Venture Capital/Growth Equity,
- 15% in Distressed Debt/Special Situations.

Those percentages roughly correspond to the most recent historical market capitalization of the private equity strategy universes.

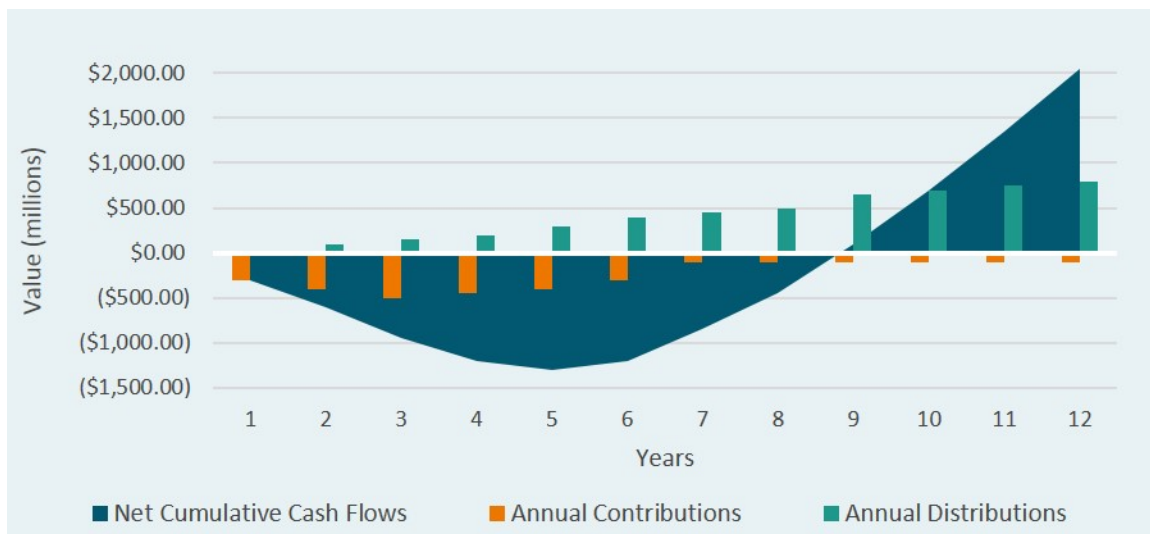
Too much diversification is also problematic as performance becomes constrained by the lack of differentiation from the "market" portfolio and as fees/costs eat into your returns. Having a more limited number of manager relationships allows investors to better monitor their portfolios and reduce legal and administrative costs. If manager selection is successful, concentration by manager will allow for winners to have a larger impact on performance. In general, a strategy's risk and liquidity profile drive how we size individual commitments, thus the least liquid investments like venture capital will have smaller commitments than large-cap buyout or debt-related funds.

Manage the j-curve

What is the j-curve?

The term j-curve comes from the shape of the cash flows and expected performance that private funds and portfolios tend to exhibit. In the first 1-7 years of a private markets fund life, the manager is drawing down capital to fund investments and pay fees/expenses. The path of cash flows and early fees on committed capital that have had insufficient time to produce an upside on investments results in a negative IRR in the first few years of a private market fund investment. This j-curve effect can create a meaningful return headwind for investors with large commitments to private funds in the early stages of a private market program's funding.

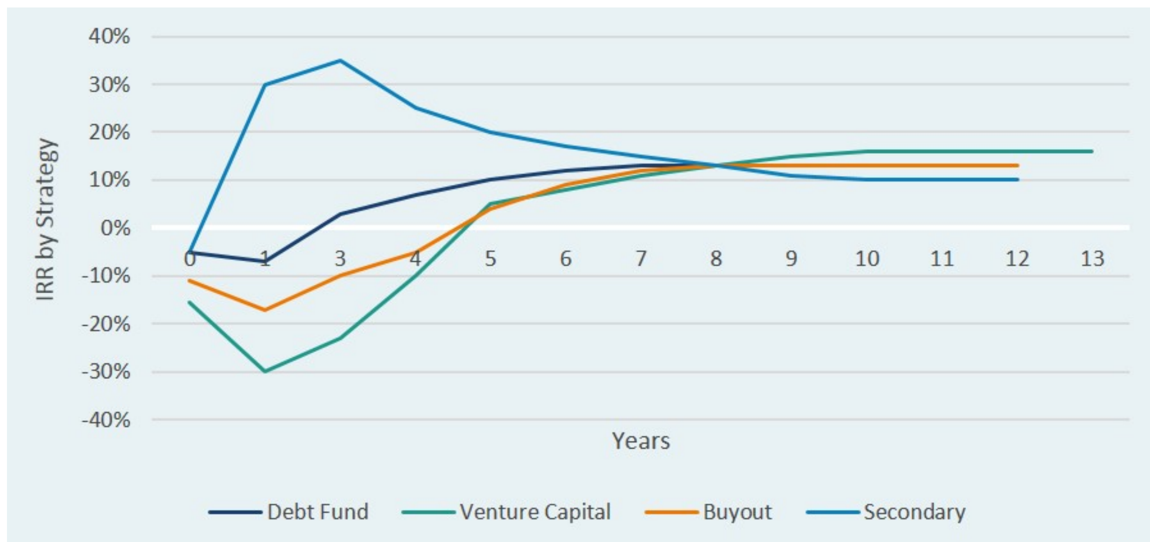
PRIVATE EQUITY - CASH FLOWS



Ways to mitigate the j-curve

Recognizing a general trade-off between achieving a high IRR versus a high multiple of invested capital (MOIC), some investors build an expectation of an elongated J-curve, while others opt to mitigate the j-curve by utilizing strategies that exhibit little-to-no j-curve. Two strategies that can help mitigate a deep j-curve are secondary investments and debt strategies. Secondary funds exhibit abnormally high IRRs early on as investments typically purchased at a discount to NAV are re-valued after the transaction closes, generating an immediate return pop. Debt strategies typically invest capital quicker and importantly provide distributions faster, often within the first year. Relative to investing in equity-oriented funds on a primary basis, debt and secondary funds can mitigate the j-curve, but also tend to produce a lower multiple of capital. Investors must weigh these tradeoffs during portfolio construction.

IRR PROFILE BY STRATEGY



Conclusion

Effective portfolio construction is an important component of achieving attractive return targets in private markets. Investors that commit to funds on a direct basis and appreciate the nuances of portfolio construction have a clear edge over others. Consistently based on our experience, they seek to commit to the most capable managers only; mindful of their ability to source and evaluate such managers and to structure their portfolios to meet their unique circumstances and objectives.

Notes & Disclosures

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