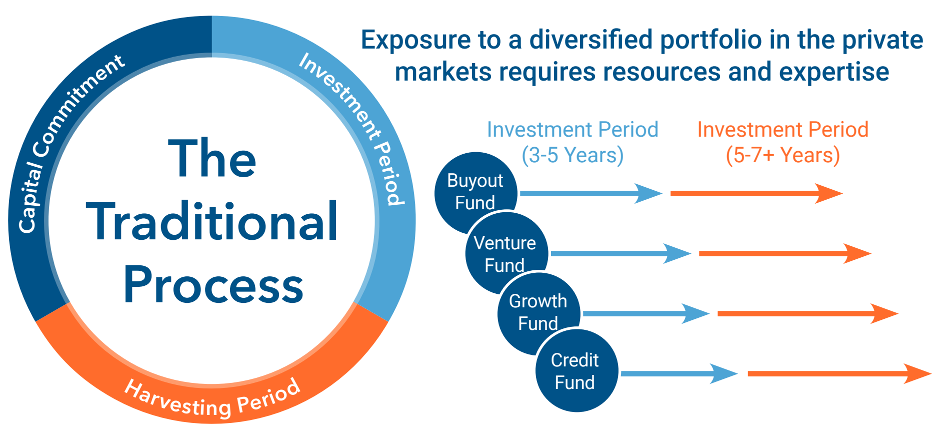
DOES INVESTING IN PRIVATE EQUITY HAVE TO BE THIS HARD TO GET TO?

By Mike Ryan, Head of Product Development and Evergreen Portfolios

Vintage year pacing, capital calls and 12-year fund lock-ups – is that really the only path to the promised land of private equity?

Traditionally, the benefits of private equity investing have been enjoyed by long-term, well established, institutional investors with a dedicated presence in the asset class. That's because the private markets have a high barrier to entry, they're largely illiquid, and require teams of resources and expertise to make informed decisions. We even put together a little graphic to simplify a complex, years-long process.



The large institutional investors have grown used to the way traditional, opportunistic investment pools in the private markets are structured. We line up to invest in 12-year illiquid vehicles, then we fund capital calls at irregular intervals and wait for the money to come back from exits. We tolerate all of this because investing in illiquid structures has done well for institutions. As illiquid funds have grown to be the market standard, investors in this asset class have a wide variety of options providing a significant amount of portfolio choice in terms of target geography, strategy and style. (Hamilton Lane will likely review approximately 900 proposals from managers raising capital this year alone.)

Once investors have built an allocation over five years or more, it can become difficult to rebalance as circumstances or market opportunities change. While private markets veterans are well-adjusted to this state of affairs, these aspects of the asset class can be administratively burdensome, especially for smaller groups and those used to operating in liquid markets. Despite these challenges, the return premium realized by private funds over the decades is what continues to draw investors.

In the global search for such returns, there has been an increasing focus on broadening access to the private markets beyond the defined pension schemes and the high net worth class. Given the allure of higher returns and the challenges involved with achieving them, it should be no surprise that investors have developed several structures offering exposure to PE without all of the hassles, such as private equity replication strategies, listed pools of private assets and open-ended funds of private assets, each with advantages and challenges. But do they really offer a shortcut to the same place, or a weak imitation of the original?

PE Replication – Smart Beta

Quantitative investors in the public market have popularized the view that any apparent investment outperformance can be replicated by mapping an investment portfolio to a set of liquid risk factors. For example, rather than investing in a small cap value mutual fund, an investor could algorithmically create a portfolio of small listed companies with value characteristics. This can even be done with lower fees, greater liquidity and full transparency.

A few intrepid souls have extended this logic to replicate the return premiums of the private markets. But to be clear, this is not investing in an index of private companies; rather, it is an attempt to recreate private market performance by mapping similar "factors" in the public markets.

On its face, the proposition is compelling. Public markets are liquid, and an investor can gain exposure quickly. The fees charged by a quant model can be much lower than a 1.5% management fee and 20% carry in PE. And, these models can produce simulated returns going back decades with quite compelling returns.

But let's read the fine print, shall we? A strategy branded as a private equity index could in fact be a hedge fund-like quant model running a leveraged public equity portfolio. This approach assumes that any private markets return premium comes from industry selection, small company risk and leverage that can be replicated in public markets. But what if PE really does work best when managers buy and sell in inefficient processes, practice balance sheet management and seek to make real operational improvements as we claim it does? These require investor control and an illiquid structure – factors that the "replication" approach just can't capture.

In my prior career as a hedge fund investor, my mentor was fond of saying, "Quant models work until they don't!" From what I have observed in the years since, that adage is correct more often than not.

Listed Private Equity

Another approach – listed private equity – is found in two flavors. One is GPs who have listed stakes in their asset management companies, which we aren't going to focus too much on in this article. While these may be attractive investments on their own merits, they provide very different exposure from a traditional limited partner's portfolio.

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But there are some listed vehicles that hold portfolios of private assets and offer distinct advantages, which is the other flavor that we'll talk more about here. For a small minimum investment, an investor can gain exposure to a diversified portfolio of private assets. Buying a stake in a listed entity like this one is logistically much simpler than subscribing to a private vehicle and funding capital calls over a period of years. And to top it all off, such vehicles can often be purchased at a small discount to the reported value of the underlying assets. Sounds great, right?

But there are snares along the path. While listed vehicles do away with capital calls from their shareholders, they still have to manage cash to fund uncalled commitments to their underlying investments. If they choose to hold significant cash and liquid assets, that can be a drag on investment returns. If, on the other hand, they follow an aggressive overcommitment strategy, they may be unable to meet cash needs and become insolvent in a market crisis. Because of such concerns, an investment purchased at a small discount to underlying value may trade at a large discount in periods of market stress, potentially erasing any return premium available from private asset investing.

Both smart beta and listed private equity remind me of the Paris Hotel in Las Vegas: certainly easier to get to, but it's not quite the real thing.

The Paris Hotel & Casino in Las Vegas. C'est le meme chose, non?

Open-Ended Funds

A handful of asset managers have adapted the fund structures used by hedge funds and core real estate to apply to investments in private equity. In these open-ended funds, investors can subscribe on a monthly basis, buy in to an existing portfolio at fair value and redeem or rebalance some portion of the exposure on a periodic basis going forward.

The open-ended fund structure has many favorable characteristics and generally caters to a different investor base. Investors can make a single commitment to gain exposure to the target asset class. This single commitment avoids some of the traditional administrative burden of operating a fund and thus allows managers to offer access at lower minimums. Additionally, by offering subscriptions and redemptions at fair value, this open-ended structure eliminates discounts that are frequently present with listed assets. Due to these attractive characteristics, many wealth managers offer these structures to the high net worth community.

Despite the appeal to the end investor, this structure can be challenging for asset managers. Indeed, a manager offering a traditional fund-of-funds portfolio in an open-ended structure could run into problems. The liquidity offered to investors in this structure simply does not match that of a portfolio of private equity fund investments. To bridge the gap, a manager could hold a high cash balance to fund capital calls and redemptions, but the low-returning cash could drag on returns to the end investor.

These challenges can be solved, but a successful open-ended private markets fund requires thoughtful portfolio construction and access to direct deal flow. The manager needs to deploy the capital in a diverse mix of investments, some to offer longer-term return and others to provide current yield and more defined liquidity. This combination requires an experienced and knowledgeable investment platform and a manager that is willing to tackle a new set of portfolio management challenges.

A well-managed open-ended fund could, in fact, offer a shortcut to real private equity exposure!

For a career investor in the private markets, the mere suggestion of earning the illiquidity premium of private equity through a fund with monthly liquidity sounds like wishful thinking. Certainly, it is not an easy thing to achieve; if it were, everybody would do it. The structure requires an asset manager to think differently about liquidity risk management, portfolio construction and delivering the premium net returns of private investments to the end investor. Still, we believe that open-ended funds can represent an attractive alternative for smaller institutions and high net worth individuals to access the benefits of the private markets. Maybe it doesn't have to be such a difficult destination to reach, after all.

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As of October 31, 2018