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Building a private markets program at smaller scale

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This paper describes the different options that small- and medium-size institutions (defined as institutions that seek to achieve private markets net asset values between $5 million and $50 million, and that are generally able to budget $2 million to $10 million annually to make private market fund commitments) have to build a private markets investment program. It addresses common questions about the types of investment pathways that may be pursued, as well as the benefits of and considerations for each option. The paper concludes with an overview of the basic steps to design and implement a private markets investment program.

The case for private markets investments

While private markets investing has become increasingly competitive as larger funds are raised and more dry powder enters the marketplace, investors continue to be drawn to private markets investing for the high return potential. In particular, private equity as an asset class has the highest expected return potential among firms that produce capital markets expectations. Horizon Actuarial Services publishes an annual survey of capital market assumptions collected from various investment advisors[1]. The average expected private equity return is higher than any other asset class, over both the 10-year and 20-year horizons:

[1] The 2019 survey included 34 respondents. The 10-year horizon included all 34 respondents, and the 20-year horizon included 16 respondents.

TABLE 1

Asset Class	10-Year Average (%)	20-Year Average (%)
US Equity	6.0	7.1
Non-US – Developed	6.8	7.7
Non-US – Emerging	7.8	8.7
US Corporate Bonds – Core	3.6	4.3
US Corporate Bonds – High Yield	5.1	5.8
Real Estate	5.8	6.8
Hedge Funds	5.3	6.2
Infrastructure	6.8	7.2
Private Debt	7.4	7.8
Private Equity	9.0	10.1

In addition to higher expected returns, private markets assets have displayed lower observed volatility historically. Unlike public market securities, private market assets are not priced daily. Private markets fund managers most often value their investments quarterly, though some private market fund managers do conduct monthly portfolio valuations. As such, price changes of an asset are generally reflected on a lagged basis in reporting, and can take as long as two quarters to reflect equivalent to changes in public securities. This can result in a smoothing of returns experienced by private markets investors.

Well-crafted private markets programs have the potential to outperform their public market equivalents for a variety of reasons. As it pertains to the investments that fund managers execute, one element that can aid in generating outperformance is a manager's ability to identify and exploit market inefficiencies. An inefficient market could be characterized as one where businesses are mispriced or misunderstood, potentially resulting in significant undervaluing. Inefficient markets may also be identified through highly fragmented industries populated with many small businesses, none of which successfully capture any meaningful market share. Private market managers, by exercising management control of business as well as having multi-year investment horizons (compared to quarter-to-quarter for public companies) can capitalize on these inefficiencies by applying long term value creation plans.

Private market fund managers generally invest their own personal capital alongside investors. This financial alignment of interest can further incentivize managers to implement value creation capabilities that foster their ability to drive outperformance. A second component that can bolster outperformance is a manager's ability to gain significant influence or control over the assets in which it invests. This influence and/or control, allows for the manager to participate in tangible, hands-on value creation initiatives – be it professionalizing the business, identifying and implementing organic growth initiatives, and/or actively pursuing merger & acquisition opportunities for its assets. These growth-focused initiatives can also be augmented by the efficient use of financing (e.g., leverage) around the assets that managers acquire.

Investors choose to invest capital in private equity funds because they expect private equity funds to deliver public market returns plus several hundred additional basis points of return. As seen in the chart below, the median performance of private equity funds raised between 2004 and 2017 generated returns approximately 400 basis points per annum over public market returns for the same period. In addition, many investors hope to achieve better-than-median returns in private equity, benefiting from the alpha that can be achieved in this space.

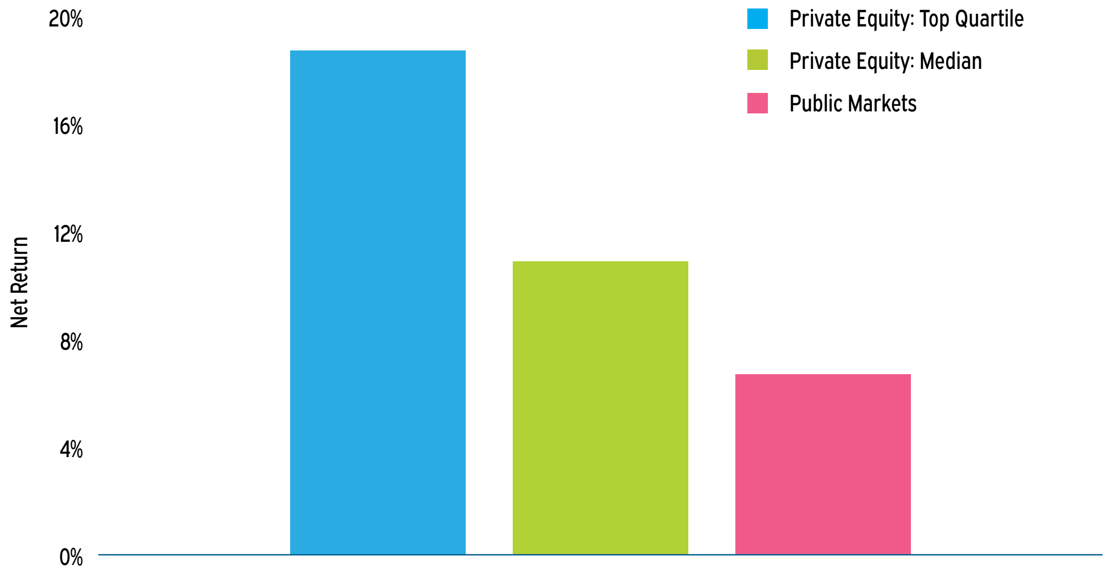

FIGURE 1

Returns: Private Equity IRRS vs. Public Market Equivalent IRRs[2]

[2] Private investment IRR data is Cambridge Associates Private Equity Index for funds from 2004 through 2017 as of 6/30/2020. Public market equivalent IRR data is MSCI ACWI from 1/1/2004 to 6/30/2020.

Fund types

Primary funds

Primary funds are commingled investment vehicles that make investments directly in private companies or assets. Primary funds are most generally structured as closed-end investment vehicles that raise a fixed amount of capital and draw down that capital from investors as needed to fund investment opportunities (in addition to covering fees and expenses). The investment teams who manage primary funds are responsible for identifying, sourcing, conducting due diligence, executing, and actively monitoring and managing the portfolio of businesses in which it invests. Depending on which private market asset class investors are committing to, fund vehicles may have a fixed term of anywhere from six to ten years (and subject to additional extensions at the discretion of the manager). As investments made by the fund are exited, the manager will begin distributing proceeds from the sale of investments to its investors until all assets in the fund are fully liquidated.

Fund of funds

A fund of funds ("FoF") is a commingled investment vehicle that invests in a portfolio of primary funds. Funds of funds are structured as closed-end investment vehicles that raise a fixed amount of capital, and draw down that capital from investors as needed to fund commitments to underlying primary funds (in addition to covering the fund of fund's fees and expenses). Fund of funds vehicles typically have a longer term than primary funds due to the variable amount of time required for its portfolio of primary funds to fully liquidate. The investment teams that manage fund of funds are responsible for identifying, conducting due diligence on, committing to, and monitoring its portfolio of primary fund investments. As primary fund managers exit their investments and distribute proceeds to fund of funds, those proceeds are then passed on to the fund of fund's investors. In an effort to further diversify portfolios or enhance returns, fund of funds managers may also opportunistically participate in direct co-investment opportunities alongside the primary funds with which it has invested and buy interests in mature primary funds via secondary market purchases.

Many private market fund of funds managers also manage dedicated secondary fund of funds investment vehicles. Known simply as "secondary funds", these investment vehicles primarily purchase interests in mature primary funds. These investments can be sourced through investors in primary funds who may be selling their interests as a quicker path to liquidity. Investors may also become motivated sellers if the life of the primary fund has extended beyond its stated term. Secondary fund managers may also source investment opportunities directly from the primary fund manager. Secondary fund interests can provide similar levels of diversification and return profiles as primary fund of funds.

Benefits and considerations of primary funds and fund of funds

Primary funds

Investors who commit to primary funds benefit from the ability to maintain ownership over building a highly customizable and diverse portfolio. Investors have the ability to diversify by strategy (e.g., buyout, growth equity, venture capital), geography (e.g., North America, Europe, Asia), and vintage year in a manner that suits the investor's risk profile and return expectations. The ability to build highly customized and diverse portfolios of primary funds is directly linked to the control that investors have over which primary fund managers they select as well as the discretion investors have over how many funds they commit to and at what commitment size. In addition to the ownership that investors have over how their private markets portfolios are constructed, investors benefit from lower cost structures versus committing to funds of funds. By investing directly in primary funds, investors eliminate an additional layer of fees that they would otherwise pay to a fund of funds manager for identifying, committing to, and monitoring a portfolio of primary funds. Primary fund investors are also privy to information pertaining to underlying portfolio holdings that they may otherwise not have access to via a fund of funds vehicle. This includes receiving quarterly financial reports, which generally provide key updates on each underlying company in a primary fund's portfolio.

Though primary fund investing affords investors a significant amount of autonomy in terms of how to build a private markets program, this control does come with a potentially significant governance and oversight burden. Running a primary funds program requires investors to maintain responsibility for identifying and sourcing their own investment opportunities. In cases where investors are just beginning to build a private markets program (as well as those with an established program), it may be difficult to gain access to high quality, sought-after primary fund managers.

Once an opportunity is identified, it is vital to execute sufficient due diligence to thoroughly evaluate the merits and considerations for investment. This due diligence process, depending upon the size of the team and the level of rigor applied, could take several months before an investment decision is finalized. The execution of new commitments typically also requires specialized legal document review and negotiation. Once a primary fund investment is executed and closed, investors may need to maintain a certain level of oversight, including but not limited to, managing cash transfers (e.g., ensuring that capital calls are funded on time and distributions are properly received), reviewing and executing legal document amendments, attending annual meetings, reviewing quarterly reports, and engaging with each primary fund's manager for ad hoc updates.

A key element of program construction is the deployment of capital at scale in order to build a diversified portfolio of primary funds. Investors will only be able to achieve adequate levels of diversification if they have a sufficient amount of capital at their disposal allocated to private market investments. Building a diversified portfolio is important because of the potential for a high dispersion of return outcomes amongst primary funds. Different macroeconomic events, competition for deals, and available investment opportunities can result in some vintage years performing better than others. Therefore, investments should be staged to ensure diversification across vintage years.

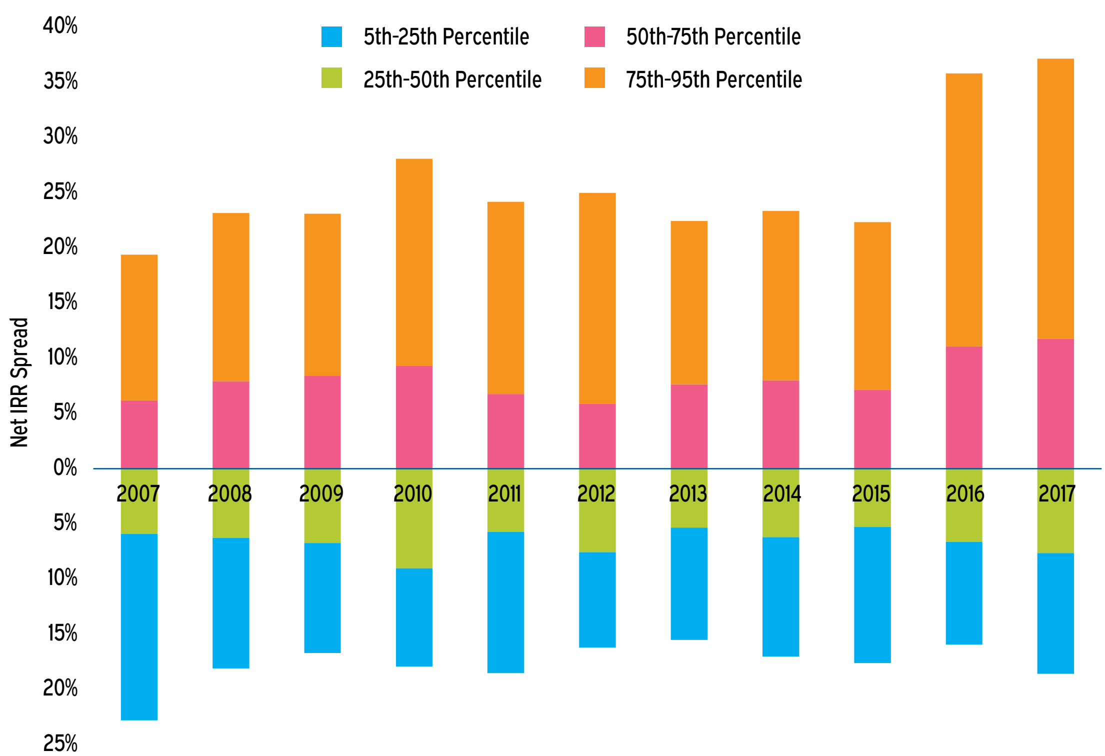

FIGURE 2

Net IRR Performance Spread Among All Private Equity: By Vintage[3]

[3] Cambridge Associates: All private equity net IRR performance for fund vintages 2007-2017, as of 6/30/2020.

As evidenced by the below chart, investors that are able to build highly diversified portfolios are more likely to experience a smaller range of performance outcomes. That said, greater dispersions of performance outcomes are not mitigated only by primary fund vintage diversification. It is important that investors seek diversification across strategy, sector, and geography. As it pertains to strategic diversification, for example, investors who make commitments to venture capital managers are putting more capital at risk due to the inherent risk associated with investing in nascent, unproven businesses or ideas. Investors can mitigate some of this risk by also committing capital to growth equity or buyout funds, which typically invest in more stable, proven businesses, and are more focused on downside protection. As it pertains to sector and geographic diversification, many sectors and geographies may be subject to macroeconomic activity that can aid or hinder the performance of businesses participating in a certain sector or geography. Investors who concentrate their exposure to a certain sector or geography that experiences headwinds due to a change in macroeconomic conditions are potentially putting their portfolios at risk for performance deterioration and a wider spread of performance outcomes. Diversifying primary fund commitment exposure by strategy, sector, and geography can assist investors in minimizing the range of potential performance outcomes for their portfolios.

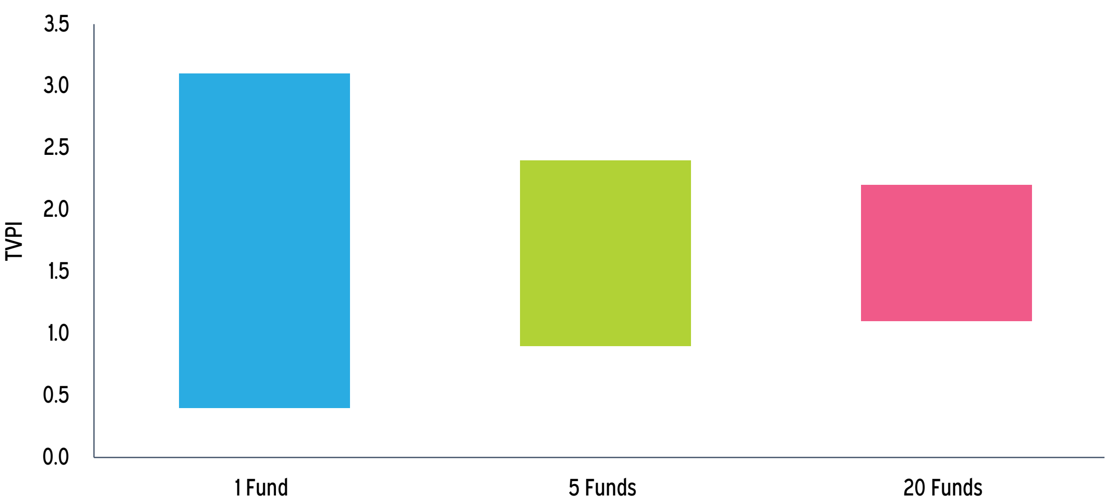

FIGURE 3

Dispersion of Outcomes by Number of Funds in a Portfolio[4]

[4] Source: "Risk in Private Equity" research paper published in October 2015. Dr. Christian Diller, Dr. Christoph Jackel, and Montana Capital Partners. Data represents full lifecycle Total Value to Paid In ("TVPI") performance for portfolios of funds.

Fund of funds

Investors in fund of funds benefit from significant diversification without being required to invest at large scale or commit capital annually to multiple funds. With a single fund of funds commitment, investors gain exposure to a variety of primary funds, diversified by strategy, geography, underlying manager, and over multiple vintage years. An investment in a fund of funds vehicle may also provide investors exposure to hard to access and oversubscribed top-tier primary fund managers that investors may otherwise not be able to invest with. This "one stop shop" also eases the administrative and oversight burdens experienced by investors that pursue a primary funds investment program. Investors only need to execute due diligence on a single fund, rather than multiple funds in a given year. Additionally, the amount of administrative oversight is significantly reduced, as investors only need to manage cash transactions for a single fund, rather than multiple funds.

Investors in fund of funds may also benefit from direct co-investments made alongside the primary funds in which the vehicle invests. These direct co-investments have the potential to enhance the performance of the fund of funds, particularly given the reduced or no fee structure that the fund of funds pays the primary funds manager for the right to participate in the co-investment opportunity. Fund of funds may also opportunistically participate in the purchase of maturing primary fund portfolios on the secondary market, which have the potential to return capital to fund of funds investors quicker and further enhance the overall performance of the investment vehicle.

While an investment in a fund of funds provides investors with easy access to a diversified portfolio, investors do not have any influence or control over the type of diversification that is achieved within the investment vehicle.

While an investment in a fund of funds provides investors with easy access to a diversified portfolio, investors do not have any influence or control over the type of diversification that is achieved within the investment vehicle. Though many fund of funds managers offer investment vehicles that are primarily oriented toward a specific strategy (e.g., buyout, venture capital) or geography (e.g., North America), there is no guarantee that the fund of funds manager will achieve the target level of diversification across strategy, geography, and/or vintage year relative to its stated strategy. Additionally, because fund of funds invest over multiple vintages, the total fund term is generally very long (upwards of 15-20 years or more), primarily because fund of funds managers are still committing to underlying primary funds four to five years into the life of the fund vehicle. Underlying primary funds fully liquidate over different periods of time. Investors who commit to a fund of funds vehicle should also remain cognizant of the extra layer of fees that they will be required to pay.

A fund of funds manager charges a management fee, typically in the range of 0.5% to 1.0% of committed capital annually, in addition to the management fee charged by the underlying primary funds to which it commits that are generally 2% annually on committed capital. That said, fund of funds managers that commit larger amounts of capital to a given primary fund may be able to negotiate a lower, more preferable management fee. Fund of funds are also subject to the same performance fees earned by primary fund managers as other investors in primary funds, typically 20% carried interest charge on fund profits. Of the 80% of profits earned by the fund of funds manager as an investor in a primary fund vehicle, the fund of funds manager will then keep a portion of those profits (typically 5% to 10%) and distribute the balance to the fund of funds investors.

As a practical example, if a primary fund to which a fund of funds vehicle has committed earns $100 of profit, $80 are distributed to the fund of funds vehicle. Of that $80 (assuming a 5% performance fee for the fund of funds vehicle), investors in the fund of funds vehicle would receive $76, split pro rata among the investors. Fund of funds managers are expected to offset their additional fees through superior manager selection and portfolio performance. However, investors that invested in primary funds between 2001 and 2015 experienced average outperformance of 270 basis points annually, net of all fees, relative to investors that participated in fund of funds, as highlighted in Figure 4 below.

Secondary funds can also be a helpful diversification tool at the inception of a private market program, as they commonly provide immediate exposure and diversification across strategies, geographies, and vintage years. Secondary funds generally purchase interests in primary funds at a point when the management fee structure and cost basis has shifted to a less expensive rate, which investors may benefit from. Whereas investors who commit capital to a primary fund do not know in which assets the primary fund manager will invest their capital (known as a "blind pool"), secondary funds have the benefit of analyzing and evaluating the underlying assets in a primary fund as part of its diligence process. This transparency into a pre-built portfolio mitigates the blind pool risk that investors face when committing capital to a primary fund. Due to the motivation of sellers to achieve liquidity, coupled with potential macroeconomic factors, secondary funds are typically able to purchase primary fund interests at a discount to the listed fair market value of the underlying assets. However, due to ever shifting supply/demand dynamics and changing competitive landscapes, at certain points in the market cycle secondary transactions may trade at premiums to listed fair market values. In addition, due to the maturing age of primary funds that are targets for secondary fund managers, such funds are generally in the process of liquidating their remaining assets. As such, the secondary purchase of mature primary fund interests may result in a significant reduction in the duration of illiquidity for investors, which can serve to decrease the "cash on cash" return of such investments.

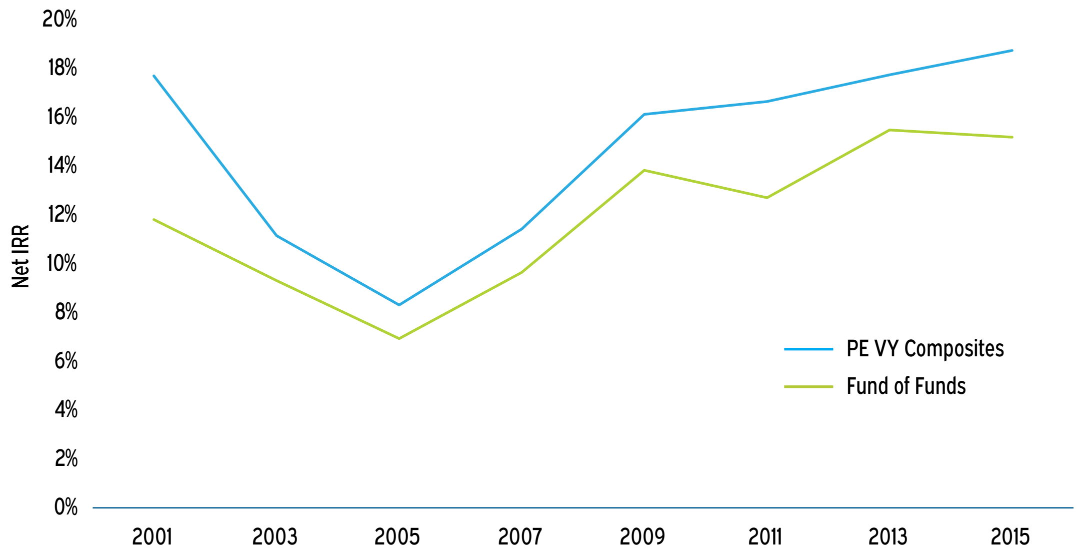

FIGURE 4

Performance Spread: Primary Funds vs. Funds of Funds[5]

[5] Source: Cambridge Associates. Difference between vintage year net IRR for Fund of Funds and a set of All Private Equity three-year portfolios with the same inception years (as of 12/31/2019).

Choosing the right approach

Investors should consider several criteria when evaluating which investment approach is right for their institution. All options have their respective benefits and drawbacks, including diversification, cost, and administrative considerations. The following chart provides a high-level overview of the investment models commonly pursued by institutional investors.

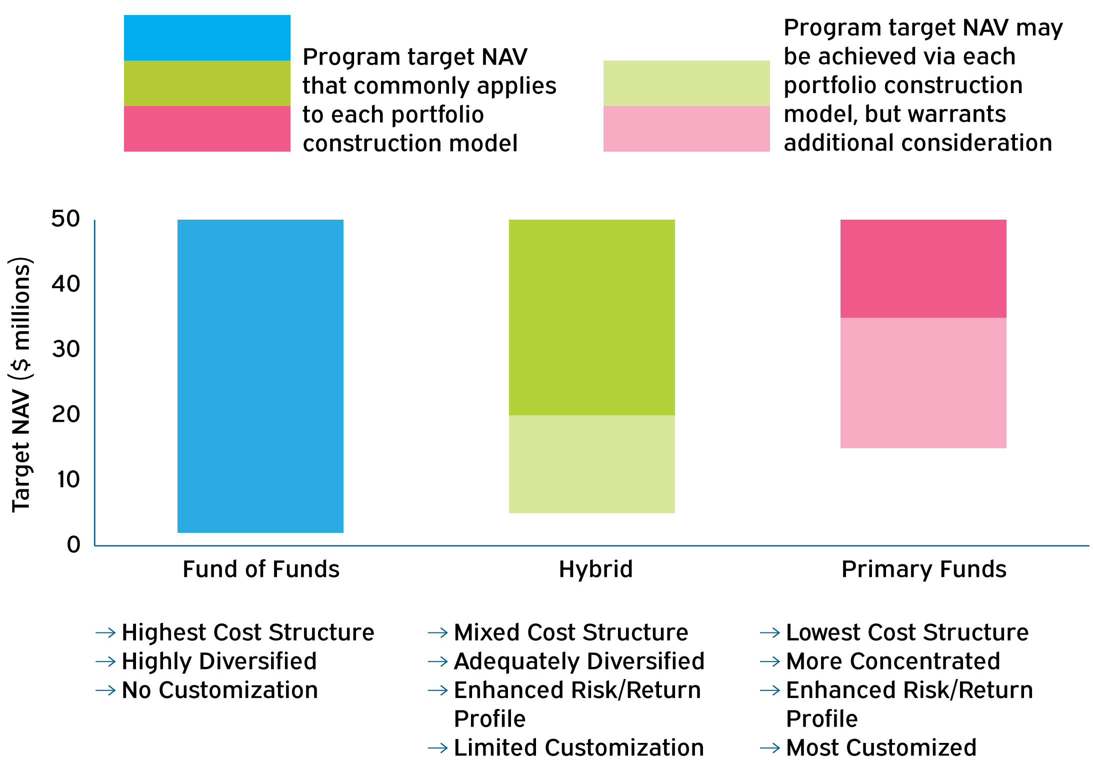

FIGURE 5

Common Investment Models for Institutional Investors

Primary funds are most often selected by institutions that have the ability to commit at least $2 million per fund to at least five funds per year. It should be noted that most primary funds have a $5 million to $10 million commitment minimum, however many primary funds will allow somewhat smaller commitment sizes, particularly if the smaller commitment is made as part of a discretionary or non-discretionary program of multiple investors managed by an advisor or consultant. Institutions pursuing primary fund programs generally seek to achieve a target program NAV of anywhere from $35 million to $50 million, though in certain circumstances we have observed institutions building primary programs with a lower target NAV. This amount of capital can allow investors to achieve an adequate level of diversification and reasonably narrow the dispersion of possible performance outcomes for the overall program.

Most primary funds have a $5 million to $10 million commitment minimum, however many primary funds will allow somewhat smaller commitment sizes.

Primary funds are also most often pursued by institutions that possess a robust staff capable of identifying and conducting due diligence on multiple primary fund managers annually, monitoring a large number of primary fund investments, and handling back-office capabilities. Alternatively, if investors have the capital necessary to pursue a primary funds program but do not possess the level and/or expertise of staffing required to manage a highly customized primary funds program, investors commonly delegate these responsibilities to a discretionary program managed by a consultant or advisor. A consultant or advisor will not only provide the services needed to manage a full scale primary funds program, but may also provide investors with exposure to hard to access and highly sought after primary fund managers. Working with a discretionary manager to build a primary funds program will also negate the investor's need to pay higher fees when investing through a fund of funds program.

Fund of funds (and secondary funds) are most often selected by institutions that do not have the capital necessary to build a custom primary funds program, as described above. These may also be institutions that are not staffed or comfortable making multiple primary fund selections annually, do not wish to manage or outsource a large roster of primary funds, or do not have the resources to identify and diligence primary fund managers (whether due to risk profile and/or staffing capabilities) and monitor them. Fund of funds also provide a level of convenience to investors with respect to the manager's ability to handle all aspects of program implementation and administration. Institutions that pursue a fund of funds approach to private markets generally invest with scale of at least $5 million in target NAV.

Institutions may also choose to pursue a blend of the two models offered above, known as a "hybrid model". The hybrid model affords investors the opportunity to gain highly diversified exposure through larger commitments to a fund of funds vehicle, while also making smaller targeted commitments to primary funds. The hybrid model offers investors an opportunity to create some level of customization within their portfolio and seek further enhancement of returns. Investors who possess the capabilities to deploy a fund of funds program as part of the hybrid model, but lack the expertise to deploy capital to primary funds, may also use a discretionary manager to build their primary funds portfolio.

Designing a private market program

Once an investor has reviewed the benefits and drawbacks of each private markets investment approach and selected a program model, it can begin the process of implementing its program. While this implementation process requires thoughtful and detail-oriented decision making, there are three general steps to design a private markets program.

Step 1: Establish guidelines and a strategic plan

Investors should consider several primary factors when developing guidelines and a strategic plan around private markets investing. The first consideration is the role that their private market allocation will serve within their overall investment program. For example, investors may seek to generate high returns while pursuing alpha, and hence emphasize venture capital and buyout investments, or they may seek steadier returns via high income investments such as private debt or infrastructure.

In addition to determining the role of private markets investments within investors' portfolios, investors also need to consider their strategic preferences for allocation of capital to various strategies, geographies, and types of managers. In order to form the basis for investors' strategic preferences, they need to first understand the benefits and the risks associated with pursuing certain investment types. For example, investors that commit to early stage venture capital funds may expect to generate higher returns than investors who commit to middle market buyout funds. However, there is typically a significantly greater amount of risk of capital loss in early stage venture capital due to the nascency of the businesses in which the managers are investing. As it pertains to geographic allocation, for example, North American and Western European markets are generally considered safer geographies in which to invest. However, well-established markets are also much more competitive, and purchase prices tend to be much higher, theoretically creating less of a cushion for profitable exits if challenging market conditions materialize.

The roles of various stakeholders within and outside of an institution must also be considered when designing types of private markets program. Investors should consider the resources, roles, and responsibilities for sourcing and conducting due diligence on investment opportunities, approving investments, legal documentation, monitoring, cash flow management, and performance reporting. Investors must consider if all of the above functions can be managed internally or if any or all functions need to be outsourced to a third-party manager.

Step 2: Develop a pacing study and road map

The primary output of a commitment pacing study is an annual commitment budget designed to approach or maintain an investor's target allocation to a private market asset class. It also helps answer questions such as:

- "How long will it take to reach the target allocation?"
- "How should commitments be allocated across time and strategies to reach ideal diversification?"
- "When will a program become cash flow positive?"

Pacing studies are also designed to support vintage year diversification. Depending upon macroeconomic events, competition for deals, and available investment opportunities, some vintage years result in better performance than others. Therefore, investments should be staged to ensure diversification across vintage years, for which the pacing study is a helpful tool in determining ongoing annual commitment pace irrespective of market conditions.

The following chart provides an example of what a pacing study may look like for an investor preparing to implement a primary fund program:

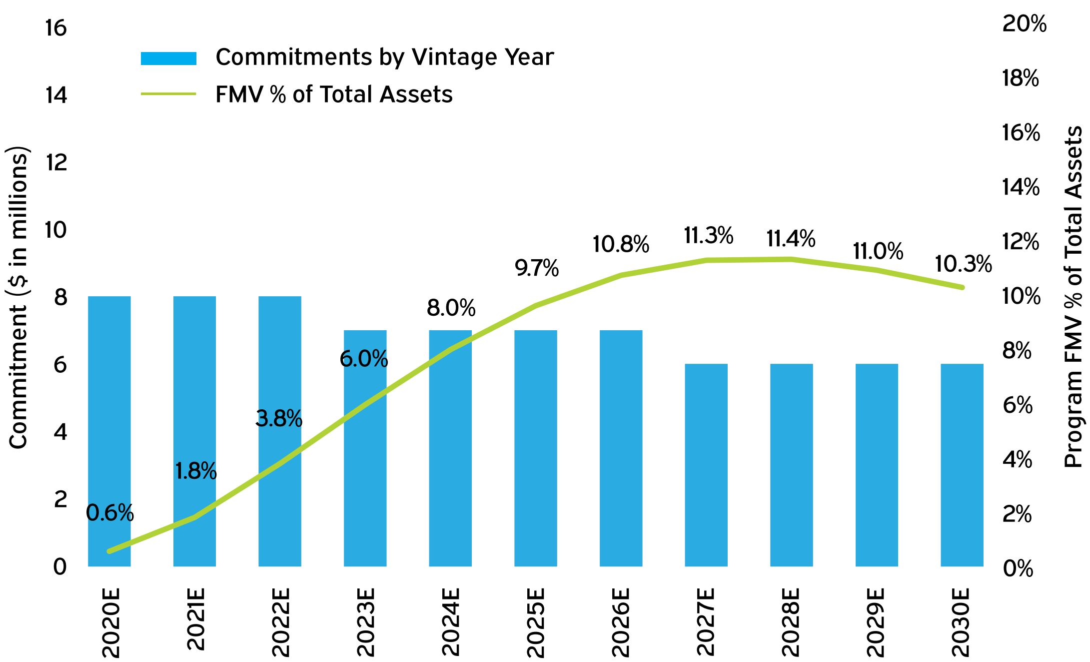

FIGURE 6
Sample Pacing Study[6]

[6] For illustrative purposes only.

In addition to a pacing study, investors should also consider scoping out a private markets "road map". The private markets road map is designed to translate an annual commitment budget into an actionable plan that aligns with the guidelines and strategic plan that investors have set out for their program. The following is an example of a private equity, primary funds road map that an investor may choose to implement over a three to five year period:

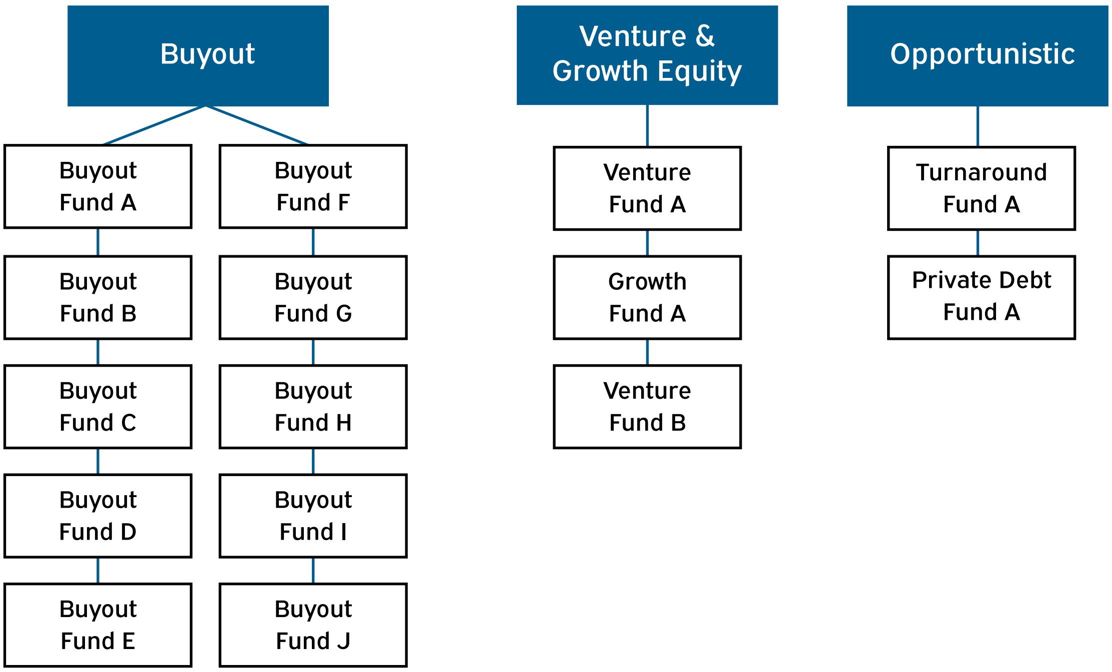

FIGURE 7
Sample Road Map[7]

[7] For illustrative purposes only.

Step 3: Implement the investment program

After carefully considering the goals and strategic plan for a private markets program, designing an annual commitment budget through the creation of a pacing study, and scoping out an investment road map, investors should now begin to put their plan into action. The following table[8] provides an example of how an investor with a target NAV of $20 million might plan its program through three program models: fund of funds, primary funds, and a hybrid approach.

[8] The hypothetical scenarios described above are for illustrative purposes only and the commitments and allocations described have not actually been achieved. The performance of these scenarios is not necessarily indicative of actual results.

TABLE 1

	Commitments per Year	Portfolio Composition After 5 Years	Additional Management Fees Above Primary Funds[9]
Fund of Funds and Secondary Funds	→ 1 to 2 FoFs every three years → $10M to $20M each	→ ~30 to 500 underlying primary funds → ~200 to 1,000 underlying assets	~$200,000 annually
Hybrid	→ 1 FoF every three years, $8M to $12M each → 1 to 2 primary funds annually, $2M to $4M each	→ ~30 to 500 underlying primary funds → ~200 to 1,000 underlying assets	~$100,000 annually
Primary Funds	→ 5 primary funds annually → $2M to $4M each	→ 15 to 25 primary funds → ~120 to 250 underlying assets	Not applicable

[9] Assumes an additional 1% management fee for Primary Funds. Does not include potential performance incentive fees payable to Fund of Funds managers. Assumes that additional management fees above Primary Funds is reflective of just one Fund of Funds commitment. Investors who commit to multiple Fund of Funds over a several year period should consult with their Meketa consultant to forecast the amount of fees they may incur.

Summary

Given the illiquid nature of private market investments and the potentially limited amount of capital that smaller-scale investors may have to deploy, investing in private market funds at a small scale poses unique considerations. While fund of funds is a common portfolio construction model for institutions operating on a small scale, private market programs with at least $5 million to $15 million of target NAV may consider whether a hybrid or primary funds model meets their goals and constraints. The most significant factors that institutions should consider when choosing the appropriate structure include: governance, administration, portfolio diversification, cost, and the long-term commitment required to participate in a private markets program. Once a model is chosen, best practice is to establish guidelines and develop a strategic plan, design a commitment pacing study and private markets roadmap, and begin implementation. To construct a successful private market program, investors should discuss and explore all of the facets to building a program prior to starting down the path of implementation.

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