PRIVATE EQUITY FAQ

1. What is the best way to measure the performance of private investments?

Unlike other investments in a portfolio, performance for private investments can be difficult to determine because of the number of cash flows these investments incur. The most common method for measuring performance is internal rate of return (IRR). This method has many drawbacks and can mislead investors (see our recent Insight on the drawbacks of IRR).

To adjust for the drawbacks of IRR, the use of public market equivalent (PME) has increased. This method takes public markets (i.e., stock market) returns and puts them through the same process as IRR. This essentially puts public markets on the same footing as private markets. Although this makes them comparable, it still has some of the same shortcomings of IRR.

At Highland, we use time-weighted equivalent (TWE). This is similar to PME except it takes private investments and puts them on the same footing as public markets, which means time-weighted returns. This allows investors to evaluate private investments in the same manner that all other investments in their portfolio are evaluated. We believe this is the best way to measure the performance of private investments because it demonstrates the return private investments are earning in the same context as the rest of the portfolio.

2. Is now the right time to allocate to private investments?

Today's low-growth, low-yield environment has lowered future expectations on traditional fixed income and equity investments. While these expected returns are lower, investors' required returns have not changed. That makes it difficult to achieve your investment objectives using traditional stock and bond markets. This has led to investors allocating higher portions of their portfolios to illiquid private investments. We have noticed this in the amount of capital raised by private investment firms. According to Preqin, capital raised by private investment firms in 2016 was $4.7 trillion, up from just $207 billion in 2000. Of the capital raised, only $3.2 trillion has been put to work, leaving $1.5 trillion in capital looking for a place to be invested. That much capital looking for a home could put a damper on returns.

While the amount of capital has increased, most of the money has been allocated to the larger, more traditional strategies. Strategies like leverage buyout have experienced double digit annualized growth (11.1%) over the past five years. Even inside of buyout, the larger funds have garnered more of the dollars than the smaller funds. This has pushed up multiples and will most likely decrease future returns.

While the growth has reduced opportunities in some areas, it has also created opportunities in others. Smaller, niche strategies have not raised as much capital, which has kept potential returns attractive. Being active in allocating capital to areas of the market that have not experienced rapid fundraising allows investors to continue to invest in private investments. Being dedicated to finding these strategies and being willing to pass up on ones that have aggressive fundraising are the keys to adding value during this part of the cycle.

3. My portfolio doesn't currently have private investments. What is the best way to start this type of allocation?

When starting up a private investment program, it is important to avoid allocating too much capital to managers in the first couple of years. Being too eager to invest could cause a portfolio to be more concentrated in certain years and create a risk of being too exposed to one type of strategy or year (aka vintage). At Highland, we prefer to have a regimented allocation program that allows our clients to spread their exposure over several vintages and takes advantage of the different types of opportunities that reveal themselves over a typical market cycle.

One drawback to this regimented approach is that a portfolio could be drastically underweight private investments for the first several years of the program. To combat this, we use several different strategies. First and most simplistic is the strategy of overweighting public markets as private markets are underweight. This allows investors to maintain a similar risk profile while the allocation is being built. Another strategy is to allocate to shorter-duration private investments—i.e., direct lending, secondary funds, etc. This allows the portfolio to generate returns similar to private markets and maintain enough liquidity to fund new commitments. The final strategy is to allocate to evergreen private investment funds. These funds allow investors to have liquidity over a scheduled period (i.e., 25% per year), allowing investors to match contributions to new funds with the liquidation of the evergreen fund.

4. What is the best way to maintain my target allocation?

After the target allocation to private investments is obtained, the work doesn't stop. Since investors cannot control the distribution of funds from managers, they must maintain an allocation discipline in order to preserve their targeted allocation. At Highland, we follow an allocation schedule that allows our clients to meet their target allocation. This schedule is dependent on the type of funds in the program and can vary from client to client. For example, one client could prefer shorter-duration funds over longer-duration funds. This would mean that their funding strategy would be more aggressive and allocate a larger portion of their portfolio each year (i.e., 35%-40% of the target allocation per year). If a client prefers longer-maturity funds, the funding strategy could allocate a smaller portion (i.e., 20%-25% of the target per year).

Having a stated funding policy is a good step in maintaining a target allocation. It is also important to stay dynamic in committing capital. Although investors can control how much they commit to each manager, they cannot control how fast or slow those managers will call capital or return capital. Because of this, investors need to continuously monitor and adjust their funding strategy to ensure the proper level of investment is maintained.

5. Is access to the well known managers imperative to having a successful program?

Many advisers and consultants often tout their ability to get their clients invested into the most well known, largest funds in the market, even if those managers are closed to new investment. In our experience, having an allocation to these types of funds doesn't determine the success or failure of a private investment allocation. Our research has shown that most investment strategies have an inverse relationship between alpha and assets under management, meaning the more assets under management, the lower the overall alpha. This is the case with public equities, hedge funds, and even private investments. We have found that the higher the assets in a particular fund, the lower the returns are compared to smaller funds. For example, smaller buyout funds typically outperform larger buyout funds by 1.8%-2.1%[1] per year . In addition, we have also found that earlier funds also have a performance premium over older funds. While gaining access to top managers is needed to have a successful program, the top managers are not always well known or older firms. Therefore, maintaining a disciplined approach to finding the best investment managers and holding them to standards is the only recipe for success.

[1] *Source: Preqin database of buyout funds from 2000-2017 and based on top quartile returns for managers under $500 million versus top quartile managers over $500 million over 5-year and 10-year time periods.*