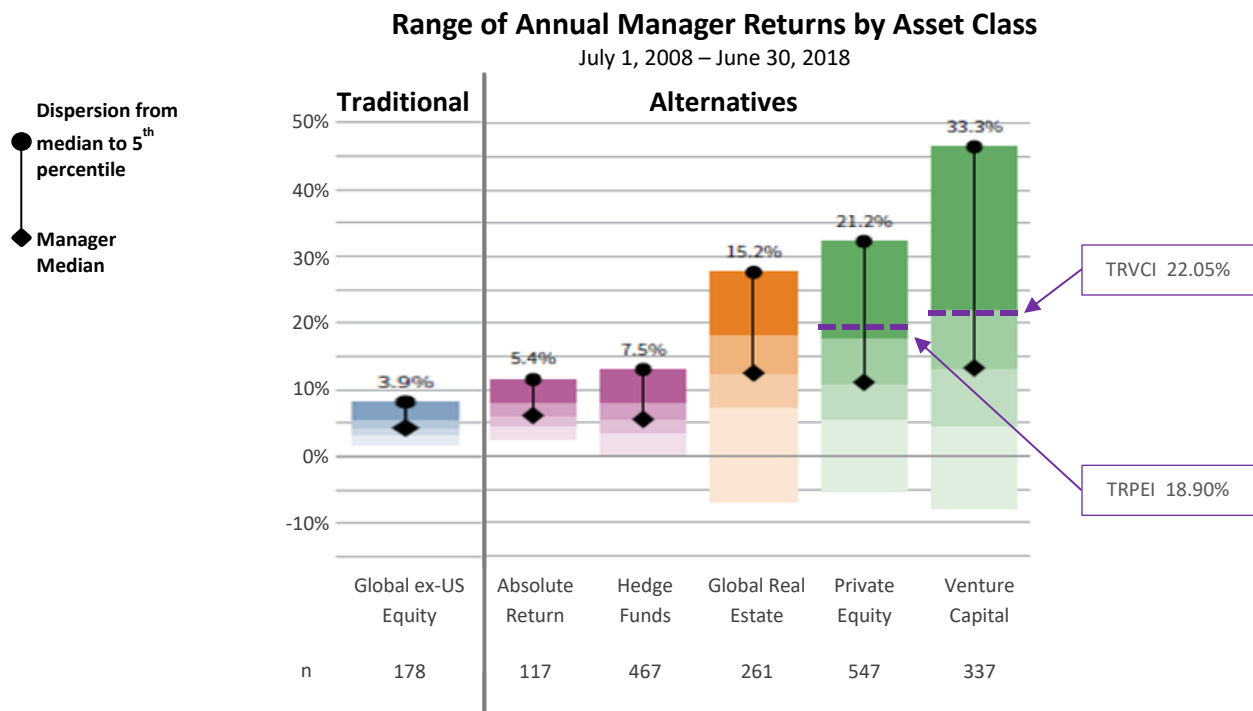


Passive Investment in Private Equity: Boosting Efficiency in a Complex Asset Class

Private equity has long served an important role as a high-performing asset class in institutional investors' portfolios. Now with new investment techniques available, what potential role is there for passively investing in private equity? Passive investment isn't a concept often thought of in the context of investing in private equity. However, given the opaque and secretive nature of the industry, in some respects the rationale for passive investment may be even more compelling for private market investments than for public equities.

Beyond the attraction of lower fees generally associated with passive index-based strategies, there are several reasons why investors may opt to use passive investment strategies for their allocation to private equity. First, it is very difficult to consistently identify top performing managers in any asset class. In the world of private equity, this undertaking is even more consequential than with public equities due to the larger dispersion of manager returns. Second, the measurement of performance in the asset class is far from uniform and straight forward. Third, evidence suggests that outperformance of a particular manager may not be sustainable. Let's consider each in turn.

The greater dispersion of manager returns in private equity than traditional equities means that manager selection has an even greater impact on investment return outcome. Since private equity managers are not benchmark-driven in the traditional sense, they take greater levels of active management risk. A wider return distribution is the natural outcome, as evidenced by the below graphic.





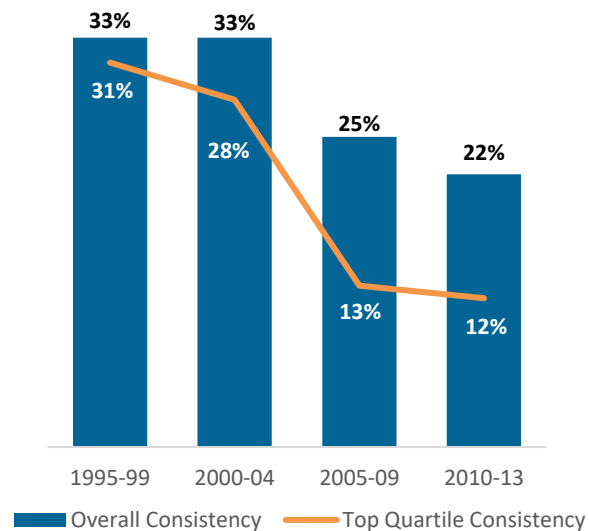
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In addition, private equity funds tend to feature significantly more concentrated portfolios (usually 10 to 15 investments) than traditional equity manager portfolios. Often times, investors will seek to reduce the private equity manager and fund-specific risks by diversifying their investments across vintages and among managers within vintages (alternatively, they may select a fund-of-fund manager to do this if their allocation is on a smaller scale). In some cases, investors end up effectively indexing the private equity market themselves, despite the intention to partner exclusively with top quartile managers – and at a substantial cost.

In addition, the lack of uniform reporting standards makes comparing private equity manager fund performance more challenging than other asset classes. Initial assessments usually center on Internal Rates of Return (IRRs). However, simply relying on IRRs is insufficient as it ignores important dimensions of fund performance. For example, as capital is called and distributed over the lifecycle of a fund, private equity managers are generally not fully invested at all times. Incorporating additional metrics to understand how much of the committed capital was deployed and returned to investors, and over what time periods, would provide a better picture of a fund's performance. Also, the Institutional Limited Partners Association (ILPA) recently identified the use of Subscription Lines as another practice that makes evaluating and comparing funds and managers on like terms materially more difficult for private equity than for traditional equity managers¹. All in, comparing private equity managers to each other on a level basis requires substantial ongoing work. And it's even more difficult to compare private equity to other asset classes, where Time Weighted Returns are the norm.

Due to the large dispersion of performance among managers, selecting top managers is critical to asset class success and investors have long factored in past performance. Unfortunately, several recent studies suggest that performance persistence of top quartile managers is diminishing. For example, a recent Pitchbook study showed that after breaking managers with three or more funds into performance-based quartiles, less than half of the funds of the highest ranked managers delivered top quartile returns². Similar research on the topic by McKinsey finds that persistence among top quartile managers has continued to drop over time.

PE Funds in Same Quartile as Immediate Predecessor



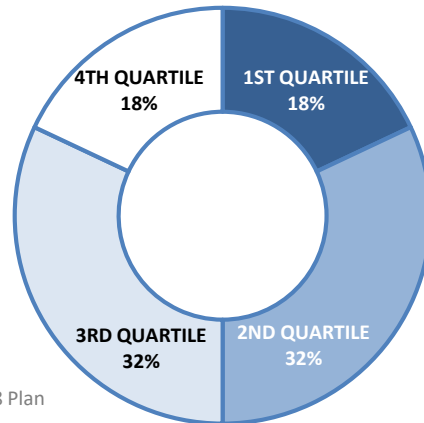
Source: McKinsey and Co., 2017



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And to focus on a specific long-term private equity investor that has committed over \$40B to the asset class over a nearly 30-year period, Oregon Public Employee Retirement Fund's own analysis indicates that only 18% of its private equity investments have been in top quartile funds (see below graphic). This suggests that manager and fund selection of blind pools of capital is indeed challenging – even for the most sophisticated institutional investors.

Oregon Public Employee Retirement Fund – Private Equity Partnership Investments by Quartile



Source: OPERF PE Annual Review & 2018 Plan

Until recently, there hasn't been a credible investible private equity benchmark to provide a diversified, passive alternative to active management. A passive benchmarking approach obviates the need for an expensive due diligence infrastructure and sophisticated treasury management capability to manage capital calls and distributions, while also providing traditional Time Weighted Returns. It can also mitigate and reduce J-Curve issues and concentration risk as well as provide improved liquidity.

For large investors, a passive private equity allocation does not need to replace active allocations, but rather could be used as a tool to complement an existing program. Using a passive instrument to generate diversified exposure allows a portfolio manager to capture private equity returns immediately – whether to maintain portfolio target exposure levels or while waiting for a desired manager's next fund to come to market. And for investors without the size and scale to support a dedicated private equity team, a passive investment option could represent a compelling alternative to a funds-of-funds investment.

¹ "Subscription Lines of Credit and Alignment of Interests," Institutional Limited Partners Association, 2017, ILPA.org.
² "Analyzing Persistence in Private Equity Fund Performance," Nico Cordeiro, Bryan Hanson, Kory Hoang, PitchBook, 2017, pitchbook.com.