SVETLANA M. LOSHAKOV, CFA, SENIOR MANAGING DIRECTOR, ALTERNATIVES

PRIVATE EQUITY FACES OCCAM'S RAZOR

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INTRODUCTION

In early XIV century a Franciscan theologian and philosopher William of Occam proposed a principal that bears his name and is known as Occam's Razor—"pluralitas non est ponenda sine necessitate," meaning "plurality should not be posited without necessity." To say it differently: of two competing theories, a simpler one is preferred. It would be a stretch to directly apply this principal to private equity investing, but it makes sense to keep it as simple as possible.

Many inherent characteristics that made private equity so successful also create unique challenges for investors. One of the important structural differences is the notion of a commitment. Private equity investors make commitments, not investments. Commitments are called by fund managers over a period of several years, while investors have no control over timing of capital calls. Therefore, commitment management plays an important role in implementation of a successful private equity program and is inextricably linked with asset allocation and liquidity management.

THE CLEARSTEAD SCHOLARSHIP

Clearstead's Diversity & Inclusion Council has announced a scholarship in partnership with the Ohio Foundation of Independent Colleges (OFIC), a non-profit which has 33 member colleges and universities throughout the state.

The Clearstead Scholarship will help talented students pay for their education and open the opportunity for internships and employment with donors such as Clearstead.

The criteria for the Clearstead Scholarship include:

- Attendance at one of the 33 OFIC member colleges
- Financial need
- Ohio and U.S. Resident
- Students of color
- GPA 3.0 or higher
- Major in Accounting, Finance, Economics, or Business Administration

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Questions such as "How many commitments are sufficient to achieve a diversified portfolio?", "How to size a commitment?", and "How to treat unfunded commitment for the purposes of asset allocation?" fill board rooms of pension plans and family offices alike. This is where keeping the Occam's Razor principal in mind would be wise.

COMMITMENT MANAGEMENT

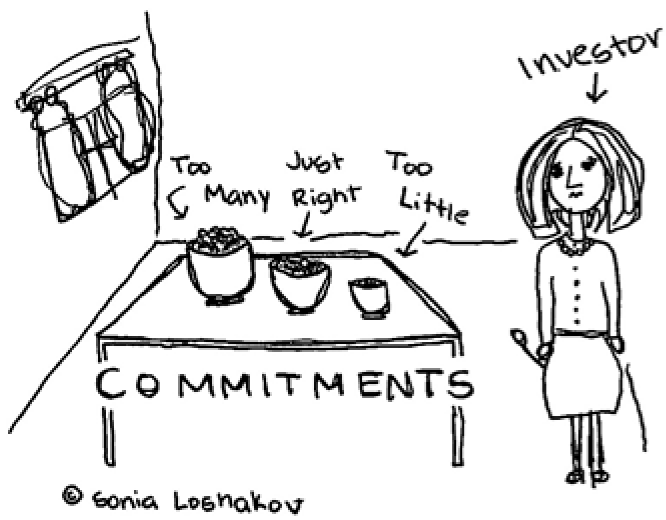
Building a diversified private equity portfolio is the key to achieving superior long-term performance and managing liquidity risk. Opinions vary on the optimal number of relationships and commitments, but practitioners agree that private equity portfolios should be diversified by vintage year, strategy, geography, size, and manager.

The portfolio construction process begins with asset allocation; however, unlike most public asset classes, private equity does not easily lend itself to traditional portfolio optimization, which relies on actual market values as building blocks for any statistical analysis. In private equity, market values are not directly observable, and their estimates are provided on a quarterly basis, further obscuring the inherent volatility, and rendering traditional optimization, well, suboptimal.

There is no single "right" number of commitments in the portfolio, as it depends on multiple factors including the degree of commonality between investments and specific objectives of private equity allocation in the portfolio. Having too few managers leads to overconcentration and risk of underperformance; having too many is an expensive way to access beta where high conviction managers are diluted. It also adds significant administrative cost (conducting due diligence, legal review, cash flow management, etc.). In the spirit of Occam's Razor, portfolios should have sufficient funds to achieve the objective, but no more.

The sizing of a commitment plays an important role in risk management. Steady, similar-sized commitments each year offer the best vintage year diversification and ability to evaluate fund managers on a continuous basis. However, it takes time to build the program and reach the desired allocation level.

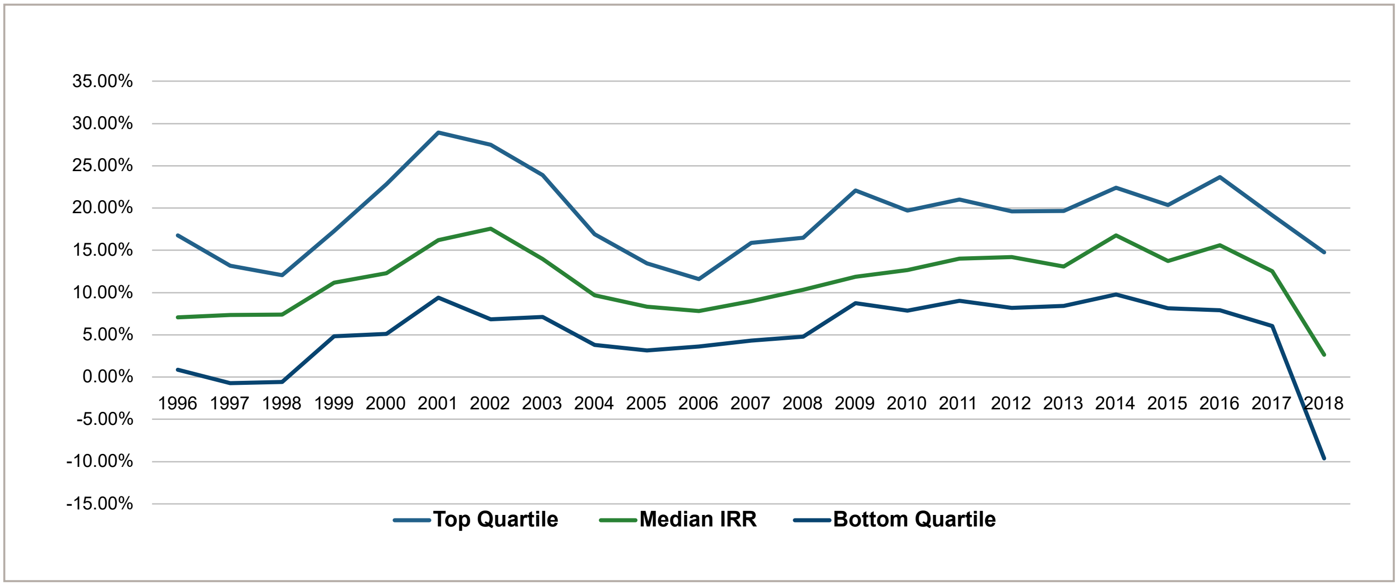
According to Pitchbook research,[1] spreading annual commitments across ten funds compared to a large commitment to just one fund cuts standard deviation of quarterly capital calls in the first three years by half from 8% to 4%. It also reduces the cash flow forecasting error as under- and over-estimation of capital calls from different funds offset each other. But increasing it five-fold from 10 to 50 reduces the standard deviation by only 0.7%, from 4% to 3.3%. Adding complexity often has diminishing results.



VINTAGE YEAR DIVERSIFICATION

Private equity goes through cycles, and since investors have no control over timing of investment activity, the least they can do is spread out commitments across vintage years. In the last two decades, 2006 was one of the worst vintages for private equity. Fundraising was brisk, valuations were rising, and leverage was abundant, leading to many all-time highs. The global financial crisis that followed two years later unleashed losses and permanent destruction of value in many portfolios. However, funds that had dry powder when the crisis struck, such as 2007-2008 vintages, fared much better.[2]

Private Equity IRRs by Vintage



Source: Pitchbook, Clearstead as of Q4 2019. Past performance is not an indicator of future results.

Vintage year diversification also helps to construct a portfolio of funds that are at different points of the lifecycle, assuring that capital calls from younger funds could be met with incoming distributions from more mature investments.

Adherence to a simple commitment pacing also helps to mitigate behavioral biases. In the rising valuation environments investors can be afraid of being left behind, experiencing the infamous FOMO—"Fear of Missing Out." How many felt that way about the SPAC frenzy? Overconfidence can be damaging to the long-term portfolio performance and cause overcommitment.

The opposite takes place in declining valuation environments. Fearing losses, investors can behave more cautiously, taking risk off. During market dislocations, investors' focus can shift to the near-term and they may reduce or pause new commitments, missing unique investment opportunities. The second quarter of 2020 offered an example of this sentiment amid the COVID-19 pandemic.

Having a simple and executable plan fights the urge to follow the crowd and creates discipline. It also helps investors focus on long-term investment goals, as crises too shall pass.

Finally, investors should recognize the inherent conflict between vintage year diversification and opportunistic commitment pace. Practitioners tend to think of the annual commitment pace as a rolling 3-year target, embracing the idea that the actual pace will be driven by compelling investment opportunities, relative valuations, and global economic outlook.

UNFUNDED COMMITMENT

There is no standard practice of how to treat an unfunded commitment for the purposes of target asset allocation. Should it be added to Net Asset Value, as it represents investors' legal obligations to a private equity fund? Eventually an unfunded commitment will be called and invested, creating exposure to a specific fund manager or strategy. Or should it be excluded and monitored separately?

Regardless of the approach, investors should always keep an eye on unfunded commitments. When fundraising activity is heating up, the risk of overcommitment is increasing, and so can the liquidity risk. Harvard University's endowment's experience during the 2008 global financial crisis serves as a somber reminder that even the smartest investor can be caught off guard and forced to sell illiquid assets at deep discounts.[3] To avoid the liquidity crunch, investors should pace themselves and remain disciplined during periods of rising confidence.

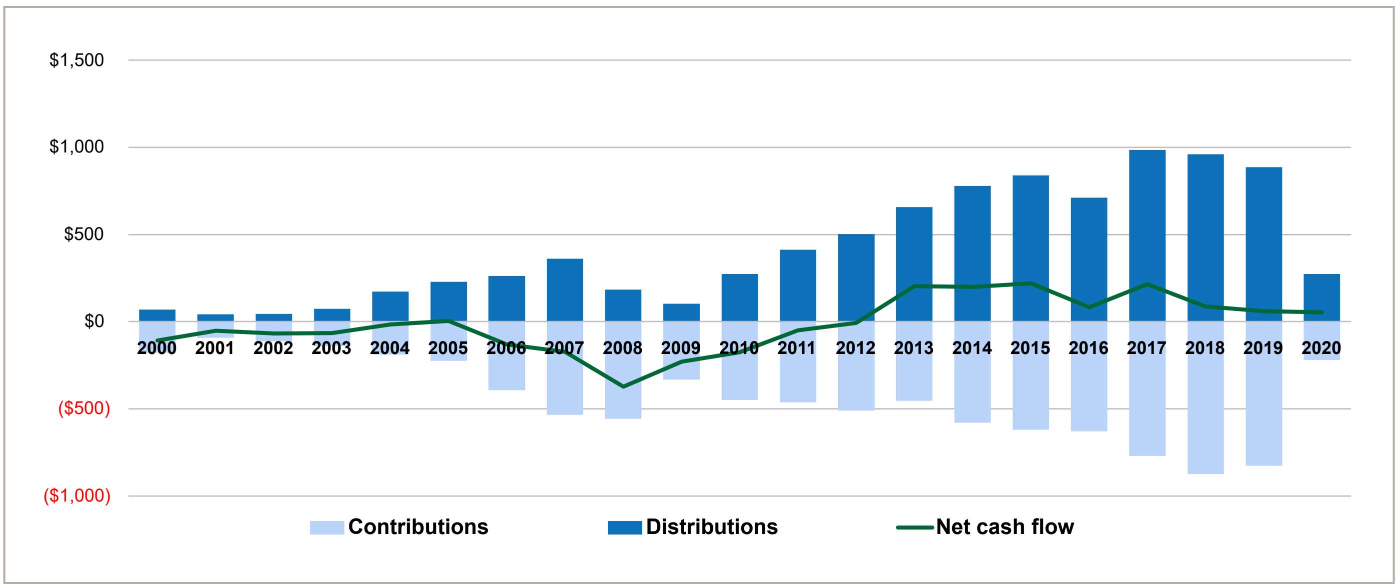
In recent years increasing popularity of fund-level credit facilities that breach the gap between capital calls and funds' acquisitions only amplify the importance of unfunded commitment tracking. It is not uncommon for the capital calls to be aggregated and delayed and in some instances, investors may even receive distributions without contributing any capital, as transactions are done utilizing the credit lines. Assessing the actual exposure and calculating the asset allocation becomes a challenge in these circumstances.

In managing unfunded commitments, some investors are required to put aside a portion of cumulative obligations, while others rely on credit lines to cover any shortfall caused by capital calls. There is no universal solution that satisfies all investors, but various options and their prioritization should be periodically discussed to avoid fire sales.

Establishing the optimal level of unfunded commitments in a portfolio is not trivial as the analysis relies heavily on assumptions. However, practitioners have adopted a simple rule stating that at or near-target unfunded commitments should be between 30% and 50% of Net Asset Value. In a growing program, that ratio tends to be higher.

Mature programs are often cashflow positive and should fund themselves. It has been observed that capital calls and distributions are correlated, as both are dependent on the general market environment and the level of M&A activity.

In the rising markets, deals get done and investors experience a growing level of both capital calls that fund acquisitions and distributions received from exited portfolio companies. When capital markets freeze, deals are put on hold, leading to a trickle of capital calls mostly to fund fees and expenses. Likewise, distributions slow down until M&A activity resumes.



Source: Pitchbook as of Q1 2020.[4]

The best practices recommend incorporating unfunded commitments into portfolio modelling and scenario analysis.[5] Dynamic asset allocation that combines actual exposure with cash flow projections tied to unfunded commitments can allow investors to account for future liquidity needs and validate projected asset allocation.

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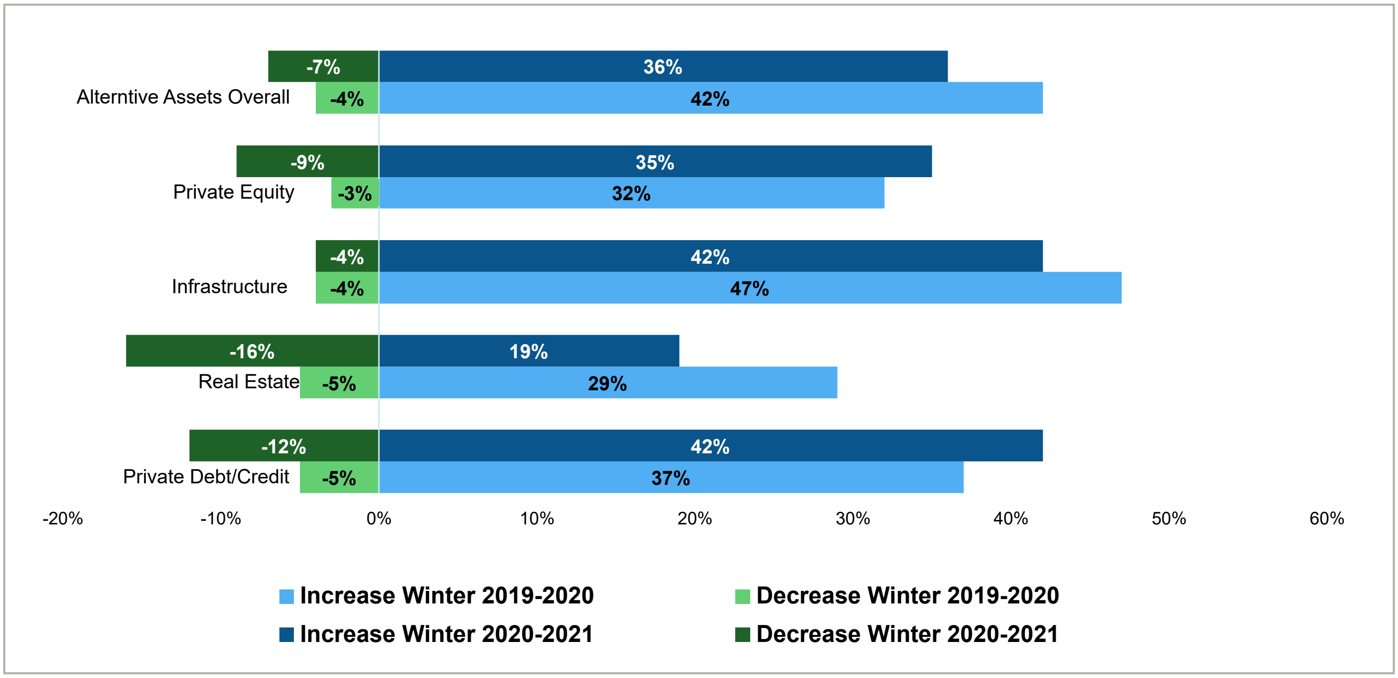
GROWING PRIVATE EQUITY ALLOCATION

Investors' appetites for private equity have been growing during the last three decades. Even the pandemic and market volatility that followed have not tamed investors' demands. The limited partner survey conducted by Coller Capital shows increasing allocations to alternative assets in investment portfolios.[6]



Source: Coller Capital Semi-annual survey Winter 2020-2021.

A growing exposure to this illiquid asset class puts commitment management front and center.

THE BOTTOM LINE

Investing in illiquid asset classes is not a simple undertaking, yet keeping the Occam's Razor principal in mind helps to deal with inherent complexities. Sound commitment management process plays a central role in achieving investment return objectives, as it impacts both future asset allocation and liquidity. A few final points:

- Commitment planning is important, as market timing rarely works outside of major market dislocations. Much depends on the maturity of a private equity program, as it takes several years to reach the desired level of exposure. Beware of manager proliferation.
- Real-time exposure and performance information is not available and is either timely or accurate, but never both.
- The fundraising cycle can be unpredictable, and access to better managers can be limited. Managers are hard to compare as their performance is not evident even after several years. A focus on building relationship with managers that have the ability to generate alpha is very important.
- Investors should actively monitor private equity programs and incorporate unfunded commitment liability in their analyses.

Finally, remember that simple and elegant solutions are the best in life, and investing.

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Sources:

(1) Basis of Cash Flow Management. Private Fund Cash Flow Series. 2020.

(2) Pitchbook Benchmarks. Private Markets Data as of Q4 2019.

(3) Harvard: the Inside Story of Its Finance Meltdown, Forbes, February 26, 2009.

(4) Pitchbook Global Fund Performance Report as of Q1 2020. 2020.

(5) Baxter, Dan. 2018. Modelling Illiquid Assets within Multi-Asset Portfolios. Jacobi, April 2018.

(6) Coller Capital, Global Private Equity Barometer, Winter 2020-2021.

MARKET BENCHMARK RETURNS

January 31, 2021		1M	3M	12M	YTD
US Large Cap	S&P 500	-1.0%	14.0%	17.2%	-1.0%
US Small Cap	Russell 2000	5.0%	35.2%	30.2%	5.0%
Developed Intl	MSCI EAFE	-1.1%	19.6%	8.9%	-1.1%
Emerging Intl	MSCI Em Mkt	3.1%	20.9%	27.9%	3.1%
Real Estate	NAREIT	-0.2%	12.6%	-7.3%	-0.2%
Core Fixed	BarCap Agg	-0.7%	0.4%	4.7%	-0.7%
Short Fixed	BarCap 1-3Yr	0.0%	0.2%	2.8%	0.0%
Long Fixed	BarCap LT G/C	-3.0%	0.2%	7.1%	-3.0%
Corp Debt	BarCap Corp	-1.2%	1.8%	5.6%	-1.2%

Source: Bloomberg

Past performance is not indicative of future results.