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Channeling the Endowment Model for HNW Investors

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As investment advisors revisit the value of a 60/40 portfolio in a low-return environment for public equities and fixed income, a private equity fund of funds can offer uncorrelated return streams and the alpha that is so tough to find elsewhere today

Yale's endowment over the past decade has grown from just over $15 billion to over $25 billion with investment returns that have ranked first in the universe of institutions tracked by Cambridge Associates in nine of the last 10 years. Since Yale's David Swensen pioneered the endowment model of portfolio construction some 30 years ago – a strategy that over-indexes to private equity and other alternative investments – high-net-worth (HNW) investors have sought to emulate Swensen's strategy. These efforts on behalf of individual investors and family offices can fall flat for a number of reasons. However, those advisors that can access top funds and provide alpha through a substantial and diversified private equity allocation can quickly distinguish themselves among an audience seeking something more sophisticated than a 60/40 model comprised of public equities and fixed income.

In Yale's most recent annual report, the endowment highlighted that over the long term it seeks to allocate roughly half of its portfolio to illiquid asset classes, such as leveraged buyouts, venture capital, real estate and natural resources. The endowment notes that its extended time horizon is well suited to exploit the inefficiencies of investing in illiquid assets through active management. And its returns in these strategies bear this out. Moreover, research from Cambridge Associates reinforces the idea that investors who allocate proportionally higher sums to private investments, outperform those that invest incrementally in the asset class. According to the most recent Cambridge Associates LLC U.S. Buyout Index, as of March 31, 2016, the net IRRs, net of fees, expenses and carried interest, exceeded 12% over the past 20 years, easily surpassing the less than 6% achieved by the Barclays Government/Credit Bond Index or the less than 8% produced by the S&P 500 Index over the same period of time. To unpack the private equity performance even further demonstrates that the U.S. Buyout Mid-Cap Index was the best performing segment over the past two decades.

The challenge for individual investors, as many often discover, is that few have access to the top-quartile private equity managers that are often a prerequisite to match or even approach the kind of returns institutions like Yale produce, which are far better than the pooled benchmark statistics. Moreover, many advisors to high-net-worth investors may discuss alternatives as an option, though are limited to less-than-adequate public versions that may not have efficient fee structures and may not generate the returns investors would expect from the asset class. Among those are liquid alternative funds that operate through a '40 Act structure, business development companies (often trading at a discount to NAV), and the publicly held management companies of the largest PE firms, whose interests are far more closely aligned to the limited partners in their private funds. For accredited investors, a handful of firms have rolled out publicly held, non-traded closed-end funds. But even if advisors can access fund investments, if they're not backing the top-quartile managers, they risk exposure to the wrong kind of private equity, with mean returns or even worse, bottom-quartile returns. Enter the private equity fund of funds.

For the uninitiated, a fund of funds (or FoF) is a multi-manager strategy in which a fund is established to make several limited partnership commitments – diversified across strategies, managers, sectors and vintage years – to create a portfolio of private equity fund investments. Strategies often differ by FoF manager, but the value proposition for a high-net-worth audience is that a fund of funds offers deep expertise, hands-on management and oversight, and – most importantly – diversification and access to the top general partners in a given segment. Investment advisors typically offer exposure through feeder funds or pooled investment vehicles.

The Value Offered by a Fund of Funds

What is often overlooked for those eager to invest in private equity is the skillset and bandwidth required to screen, identify and invest in the best managers. For instance, in just the lower middle market alone, where many of the best-performing managers reside, there are typically as many as 250 general partners in the market fundraising every year. In order to amass a portfolio of 10 or 12 fund investments across three or four vintage years requires due diligence into and analysis of roughly 1,000 funds over that period of time. This includes meetings with GPs and placement agents, calls to portfolio-company management teams, negotiating fund terms and ultimately making commitments to three or four funds in a given year. Assuming high-net-worth investors want to manage risk and optimize the return potential offered through the asset class, they would need to deploy roughly $100 million annually to justify the costs necessary to support a team that could effectively manage an alternatives portfolio.

Another factor that is often overlooked is just how difficult it is to access the best managers. Forty percent of all the buyout funds in the market last year closed within six months or less, according to Preqin data, and nearly all top-quartile funds finished above target or were oversubscribed. High-net-worth investors, on their own, would have difficulty accessing these top-quartile funds. Moreover, the best performing funds maintain strict minimum-investment requirements – with floors set at $5 million or even $10 million – making it far easier to accommodate larger pensions or endowments that can write checks of that size. Institutional investors also have processes in place to meet capital calls in a timely manner and can even step in as co-investors when the opportunities arise. It's also worth noting that in the lower middle market – one of the most attractive segments in private equity – GPs raise significantly smaller funds than their large- or mega-market peers, often capping off at $300 million to $500 million. As a result, the top-quartile managers in this segment tend to be far more exclusive in selecting their LPs, leaving individual investors and family offices on the outside looking in.

The endowment model has proven so successful over time in part because private equity is among the top asset classes in producing true risk-adjusted returns. Yet like any other investment strategy, a diversified portfolio is crucial in managing the downside. This is another area that proves tricky for high-net-worth investors and family offices, as the investment minimums to make direct investments in funds can quickly eat up their allocations. Even among high-net-worth investors, those that can meet the minimum commitment requirements to invest in just one traditional private equity fund and then lock up the capital for six to 10 years, remain few and far between.

Given the spending requirements and rising liabilities facing universities today, the consistency and historic outperformance of private investments make the Swensen model the preferred strategy for endowment portfolios. This is becoming even more pronounced in an environment in which many investors have pared their return assumptions for equities and fixed income, which makes the uncorrelated and idiosyncratic returns available through leveraged buyout funds that much more in demand. For high-net-worth investors focused on capital preservation, asset class diversification, and the alpha offered through private equity, a fund of funds can provide advisors with an opportunity to not only meet these needs, but also differentiate themselves in a material way that resonates with sophisticated investors.

Constitution Capital Partners is private equity firm that makes primary fund investments as well as equity co-investments alongside small- and middle-market buyout firms in the US. Daniel Cahill, a managing partner at Constitution and a member of the investment committee, is responsible for the strategic development, investments and management of the firm.

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