Practical lessons for private-market investing

What practical advice would sovereign wealth funds give to their peers who were was just launching a private markets investment programme or considering doing so?

Setting the right strategy

Establish your strategy based on the expertise that you are confident that you can build in house. “Determine what expertise you require and build a team. If a fund wants to go into private assets with one or two full-time employees to follow private equity, hedge funds, and real estate, the programme is unlikely to deliver, no matter how good that person is. Establish resourcing and internal infrastructure before you even think about investing!”

Start slow

“Go into the market gradually. It takes time to build up a good team with the capability to manage private market investments, especially for direct investing. For us, it made sense to invest in fund of funds for the first few years. You pay high fees which is not attractive, and returns aren’t great, but it gives you access to the market… Then you can understand how those markets behave and inform how your fund is going to build the programme. You have to go in with that mindset and be willing to stick it out through long periods and be consistent in your deployment. You can’t slam on the brakes in bad times and then accelerate in good times.” Professor Josh Lerner agrees: “The longer you’ve had a private equity programme, the better your returns. Private markets are not an area where you can just go from 0 to 60 miles per hour overnight. You have to look at it as a longer run kind of process.”

Private markets are local markets

“Local knowledge is essential, so have a presence on the ground. Be close to deal creation, identification, and sourcing. Where it makes sense, consider joint ventures to tap the local presence of other investors. If you bring a generalised view that is inconsistent with a particular market, you will not succeed. You have to be flexible about how you actually integrate your programme and ensure it reflects differences in different markets. The US, European and Asian markets are quite different. Flexibility is essential.”

Do your due diligence

“In the private markets, you need to commit to understanding your manager and your underlying investments. You can’t sell tomorrow, so you must understand the risks and consequences associated with them. Spend a lot of time on due diligence. Do it up front, and then stay glued to the company you’re invested in. This is the best risk control there is in private markets! You need good relationships with management and other investors. We have an entire team who just follow the existing investments. With public market investments, you often don't want to appear too close to management. In private markets, it's the opposite." Professor Lerner expanded on this concept. "You really need to build relationships and understand the lay of the land," he said. "Too often we see investors taking shortcuts, investing with fund-of-funds or investing in the biggest name-brand funds. These aren't necessarily bad decisions, but there is no real substitute for building a variety of relationships, digging in to understand different market segments, and developing that experience. This process isn't easy, but it rewards those who spend time developing relationships, visiting groups, and understanding them."

Governance and decision-making structures

"The more diverse the information sources that inform a decision, the better it is! For example, you need a framework to compare private markets opportunities with public market opportunities. Sometimes the public markets are a better way to access specific risk premium. You have to understand relative prices, risk-adjusted pricing, across the largest opportunity set you can. It's very hard to do." Professor Lerner agrees that governance is important. "When you interview private markets investors and talk to CIOs about what made them successful, certainly governance is one of the points they emphasise. The successful investment committees seem to be willing to largely delegate decisions about which funds to select to the staff. What they are doing is providing broader insights into market trends and strategic input, without micromanaging the staff about individual investment decisions."

Managers: quality over quantity

"By allocating more capital to fewer managers, you will realise more efficiency in monitoring your investments. By awarding larger mandates, you also gain leverage in negotiations with managers. Negotiate lower fees, deeper access, and the option to commit more capital (or dial down commitments) in the future. There are also some patterns in the performance data that can aid in manager selection," said one fund. "If you look across private equity funds, the very smallest funds do poorly," said Lerner. "But once you get above a threshold there is relatively little difference in performance due to the size of the funds. That said, when you look at the largest deals being done by a particular fund, whether the fund is big or small, they tend to do worse than a fund's typical-sized deal. Why? With larger deals, it may be that you have a situation where the deal takes on momentum of its own and becomes a runaway train, and is harder to stop. With a smaller deal, when questions are raised, it might be easier for people to halt the deal. There is also the fact that most large deals tend to be done around market peaks and we know that market peaks tend to be the worst time to invest."

Professor Lerner also warned about investing with fast-growing managers. "Rapid growth seems to be associated with a deterioration of performance. The thinking is that partners end up trying to do too much and that ends up cutting into their performance." He also suggests looking for niche managers, "there is lots of evidence to suggest that specialisation is a good thing in private markets. If you look at healthcare, technology, or financial services, the funds that are specialists tend to do better than the generalists. There seems to be a considerable benefit to really knowing the area in which you are investing. Those are three types of characteristics of successful funds."

Be long term

To be successful in private markets you need a long-term investment horizon. "This can be done, for example, in the way that information is measured and reported as well as in the financial incentives that are offered to staff. Most successful private markets investors have had continuity of staff; in many cases, you see a successful team that has stuck together for multiple years. This helps a lot in terms of making subjective investment decisions, as well as being effective in getting access to the most desirable funds."

Invest in your team

Developing skills and commitment is challenging. Sometimes it is not enough to build a team of superstar ex-pats who will only stay for a few years. Josh Lerner believes “One thing that is important for SWFs – and this is true regardless of location – is the need to build up internal capability. You want to find young people who are willing to stay and invest time, rather than someone who will parachute in for a couple of years before retiring.” One fund suggested seconding employees to private institutions to build their skillsets. “This has proven effective in developing the in-house expertise that we need.” Lerner explained that there is an “importance of ‘stickiness’ in having a team that is around for an extended period.” To build these types of teams the idea of corporate culture is crucial, as it is this that encourages staff to stay. Compensation is an important factor, but sovereign wealth funds also need to build an organisation with a sense of mission. Lerner believes that “The mission shouldn’t be just about making money – it should be about trying to address broader goals. Having that successful feeling of mission seems to be a very important ingredient for success.”

Learning from your successes (and failures)

“The most successful investors also tend to have a process for institutionalised learning,” said Lerner. “They go through a structured process of periodic self-examination. This isn’t just about looking at their aggregate returns, but looking at why they chose funds that underperformed and why they passed on funds that ultimately did well”. Sovereign wealth funds can go through this exercise in any number of ways – through annual performance reviews, returning to original investment cases, but it needs to be systematic. “One of the things that everyone would agree is that investing in private markets is not a purely analytical process,” says Lerner. “Aspects of it are highly subjective. To succeed, you need to incorporate hard information, but there is also a lot of soft information that needs to be processed and examined. Hopefully that gives you a few clues.”