Tooling up for investing in private markets

Each of the sovereign wealth funds we interviewed spoke at length about the new capabilities and governance structures that they had needed to develop to launch a private markets investment programme. One of the major themes that emerged was the importance of people and the need to develop a qualified and talented team. “Human capability is the most important part of a successful private markets investment programme,” said one fund.

Attracting and retaining talent

As many sovereign wealth funds are based outside major financial centres, it can be difficult to attract and retain talent. One sovereign wealth fund said that while they were based in a “unique place” the challenges was that “people want to come for a few years, but they don’t want to stay forever. It is often seen as a unique opportunity for people at a specific point in their career. Turnover is always tough and expensive, but it is particularly difficult to manage in private markets because these are long-term investments with long-term relationships. The cost of turnover is higher in private markets than in liquid markets.”

The sovereign wealth funds employed a range of practices to hire, develop, and retain strong teams including:

- **Developing local staff** by cooperating closely with private equity firms, or even seconding employees to develop expertise. One sovereign fund, which invests directly in real estate but not yet private equity, explained: “We are trying to learn as much as possible from partners in private markets… We cultivate in-house knowledge through cooperation with our funds. Then we will play on our own.” Another approach is to ask private equity managers to allocate some budget for the fund’s staff to attend training seminars and conferences.
- **Leveraging external consultants** to supplement or complement in-house staff. One sovereign wealth fund explained: “We have a panel of consultants that we tap for different kinds of expertise… This has resulted in a complicated situation with lots of advisors and consultants. It works, but there are a lot of people at the table.” However, the fund acknowledges that consultants do not have the same commitment as internal resources and, therefore, it “would never outsource ultimate investment decision making or deal sourcing. These are core things that need to happen internally. If you can’t make those decisions internally, then just commit to a big fund, rather than direct investment.” The same sovereign wealth fund also believes that private equity funds should also be sourced and selected in-house. Other sovereign wealth funds leveraged outside consultants for manager due diligence.
- **Identifying staff with strong networks.** “When you’re looking for in-house talent, you want people who have access to relationships so you get the deal flow,” said an SWF.
- **Avoiding organisational silos** to enable specialists with a range of skills offer insights on each opportunity. It is also important that the team working the deal from the bottom up can combine its perspectives with the top-down view.
- **Building strong middle and back office teams in addition to a strong front office**. “It is not easy to monitor and analyse the total portfolio including traditional and alternative investments together

because their data schemes are different in terms of their timing and frequency," said one fund. Another fund had built up an internal legal team to address tax and other issues associated with their private markets portfolio.

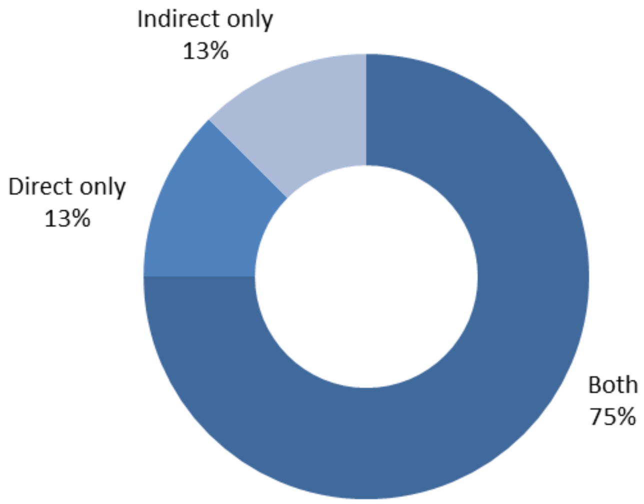
- **Building teams with a diverse set of skills**. One fund outlined its approach: We need "critical thinking and negotiation skills to deal with managers, commercial skills to structure a mandate, and relationship management skills to engage with managers and really understand what they are doing. You can't just talk to the GP's [general partner] investor relations people, you have to meet with the people who are doing the deals and understand the areas of value-add and where they see risks."
- **Retaining staff by instilling them with a sense of purpose.** "Many of our staff don't do it for the money. They could get paid more if they left for an outside company," said one sovereign fund. "There is a sense of national pride. We are doing something good for the country." But the fund also noted that as a sovereign wealth fund in an emerging market, working there provided a unique experience for nationals: "If people spend a few years here, they get to understand how these markets operate. There is nothing else quite like it in the country. So, we have to be competitive, but not necessarily in terms of pay." Professor Lerner had a similar perspective. "It is clearly not all about the money," he said. "When you look more generally, the data don't support the notion that the endowments that pay the most dollars have the best returns. It does seem to be about giving a sense of mission, autonomy and importance of what they are doing."

Going direct

The funds also noted that the type of expertise required differs depending on the fund's investment strategy. More sovereign wealth funds are investing directly, or alongside GPs, as well as in traditional funds. Overall, sovereign funds had strong interest in launching or expanding direct investment programmes. They cited a range of prospective benefits to direct investing or co-investing, including lower costs (no fees), the ability to tailor deal structures to better align with the funds specific objectives and requirements. "There are two key benefits [to investing directly]," said Lerner. "One is to save money. Two and twenty is a hefty bite. If you can be a solo investor without a private equity group or do co-investing with substantially lower fees than fund investing. You also control the timing of investment decisions: when to sell and when not to… The real question is whether performance is good enough that one ends up ahead of the curve."

Of course, direct investing requires a much larger in-house capability. Investing directly and accessing unlisted assets through funds requires different expertise. Selecting good managers and managing those relationships is different to the selection and management of the assets. One sovereign wealth fund says they do both: "We tend to invest directly in real estate and infrastructure, but invest in private equity through funds."

Exhibit 1: Do you invest in private markets directly, indirectly through funds, or both?



Source: IFSWF member survey 2016

For investing through funds, an asset owner needs to have “a deep knowledge of global GPs and the leading managers in each sector,” said another fund. “For direct investing, we need expertise in analysing the sectors and regions with local professionals. Deal sourcing and execution capabilities are important and operational expertise with sector specialists is important to facilitate a successful exit.” Several sovereign funds identified private equity as the most difficult asset class in which to invest directly. One sovereign wealth fund highlighted the challenge of measuring success of private equity funds: “It is possible to obtain more or less the benchmark return in real estate, but it is much more difficult to obtain the median return of private equity funds, let alone top quartile. We haven’t been able to build the resources to invest directly in private equity.”

There is inconclusive evidence as to whether direct private markets investing outperforms funds. Professor Lerner’s research suggests that by and large direct investors did reasonably well, “but not better than funds, even after the fee savings were considered. If they had invested in the average private equity fund, their net performance would have been pretty much the same.” He also noted that his research also showed that performance varied within unlisted assets. “Direct investors did poorly in venture capital. This space is hard to play in. There are multiple financing rounds, and our institutions were typically investing in later rounds with much higher valuations. Private equity is more straightforward: everyone is investing at the same time. These deals turned out to be more successful.” Another surprising finding from Lerner was that co-investments did quite poorly when compared to solo investments. “When these funds were investing alone, they did better than they did when investing alongside the private equity groups. We thought it would go the other way,” says Lerner. “The institutions in our sample tended to co-invest in large deals done at peaks in the market.” He also noted that investors made the most successful deals investing in their own back yard. “Of course, if you don’t have a large backyard, and you want to do a lot of direct investing, the strategy is difficult to scale, he says. “There is a challenge as to how much can you expand and have the same success.”

Getting governance right

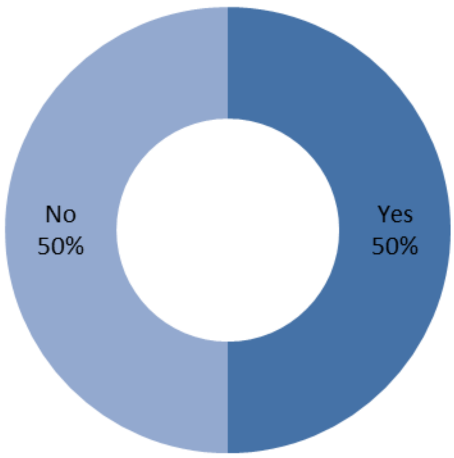
Investing in private markets brings with it an additional layer of governance complexity. As one sovereign wealth fund points out, “In private markets, you’re not only investing in the asset. You are often structuring it, financing it, leveraging it, and in some cases actually managing it.”

The funds employ a variety of different decision-making and governance frameworks. These often evolve significantly over time to give staff greater decision rights. For one fund, the CEO has approval to authorise investments if the amount is less than $500 million, whereas larger investments require board approval. Frequently, an investment committee comprised of senior staff must approve investment decisions over a certain threshold, while deals that exceed a larger threshold must go to the board. “Every deal from every team gets put before a forum that includes all asset classes and our strategy group. We debate the merits of every opportunity relative to other things we can do," explained one fund. In many cases, empowering the investment committee to approve large private deals required expanding its membership. "Our internal governance structure is crucial," said another. "We had an investment committee, but when we entered private markets, we needed to expand it to include members with suitable experience to look at transactions and make decisions."

Another fund employs a "buddy system" where the investment team works closely with the investment analysis team to evaluate opportunities. "You need strong subject matter expertise as well as analytical skills to evaluate risks associated with an investment. You need to be able to articulate why we should add a risk to the portfolio and present this argument to the investment committee" it said.

The sovereign wealth fund underscored the challenges of striking a balance between speed and rigour. One the one hand, it is important to take a rigorous, analytical, and comprehensive review of investment opportunities. On the other hand, if the process is too slow, the investor will miss opportunities. One fund told us that, "The speed of decision making is a key factor for a successful private markets programme. We introduced a separate process for direct investing to shorten the process for GP co-investment or re-up opportunities."

Exhibit 2: Have you needed to overcome challenges due to the speed of your decision-making process?



Source: IFSWF member survey 2016

A few sovereign wealth funds felt that time pressures associated with private investment opportunities were often exaggerated. "We're always told that we have two days to get rich. But it is never true. We usually evaluate deals for a couple of months. But sometimes on the last point in a negotiation, you have to decide quite fast." Another said "If we don't have time to do our due diligence, we do not invest, no matter how promising it sounds." Other funds were comfortable moving quickly for the right opportunity. "Our approval process was so long that we missed opportunities or got in too late. We've worked on improving our efficiency. We're constantly looking to make quicker decisions where we have confidence. The stronger our confidence, the happier we are to move quickly." However, sovereign wealth funds generally thought that decisions to invest in funds could be made more quickly than for direct investments.

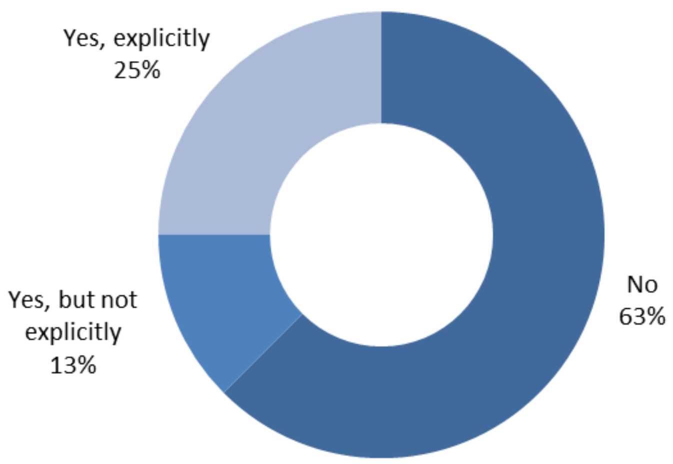
Thinking about ESG

Interestingly, despite widespread discussion in the global investment industry on the notion of environmental, social, and governance (ESG) considerations, few sovereign wealth funds imposed explicit sustainability objectives or constraints on their private markets programmes. However, these issues often arose as a by-product of other considerations, including a fund's natural interactions with recipient countries, management of reputational risk, or impact on investment performance. One sovereign fund explained: "We have always conveyed to recipient countries what we are doing and shared our views. We visited all our major recipient countries during the global financial crisis of 2008 and 2009 to tell our story: who we are, what are our objectives, how we invest, and how we make decisions. We don't publish a number, but we are very clear if the government of a country wants to know how much we have invested there."

On the topic of specific social or environmental objectives, the fund expressed some practical concerns. "This is a complex issue. If tobacco is bad – which it is – then governments should ban it. It's not a good approach to remove it from investment portfolios. In fact, tobacco is the best performing sector in the market." The challenge for sovereign wealth funds becomes how to incorporate such non-traditional financial factors into their guidelines. The same fund points out that, "We do incorporate our reputational risk, and we refuse certain investments for this reason. But environmental and social issues are difficult to incorporate into our guidelines because they are very difficult to assess."

Sovereign wealth funds did stress the importance of performing due diligence on managers and ensuring they were working with ethical and responsible partners. Some funds consider sustainability purely through the lens of investment returns. "We are about return. To the extent that – over the long term – there are environmental or sustainability issues that will impact those returns, we have to make sure that is factored in." Several sovereign wealth funds said that they consider sustainability issues as far as they could represent reputational risks for sponsoring governments.

Exhibit 3: Does your fund have specific objectives around the sustainability of its private market investments and/or strategies to ensure a welcome reception from recipient countries?



Source: IFSWF member survey 2016

Risk management

Most sovereign wealth funds had expanded their risk management capabilities to support their private markets investment activities.

Most sovereign funds we surveyed have centralised risk management functions. This team often works in cooperation with investment teams who also incorporate risk considerations into their decision-making process. Some funds see their investment teams as the first line of defence in managing risk, with the central risk function as the second line. In some sovereign wealth funds, the investment and risk (and compliance) teams must make joint presentations to the investment committee regarding new opportunities.

In many cases, a stated purpose of the central risk function was to draw connections across teams and asset classes. “The central function is looking more across the whole portfolio for hot spots, concentration, and correlation,” said one fund. “Each investment group also has its own internal risk team to assess risk. The chief risk officer sits with the risk team from each investment department – public and private – to make sure that there is good communication across teams and with the central risk function. The central function also has people dedicated to each group who spend part of their time sitting within that group.”

Risk management in private markets is complex and requires multidisciplinary input. “With direct investments, if we buy a sea port, the legal and risk factors will be far beyond what specialised investment professionals can identify,” said one fund.

Co-operation and collaboration

Perhaps the most common shared attribute among the eight sovereign wealth funds with whom we spoke was a commitment to cooperation with their peers. All of them stated that they had cooperated to some degree with other sovereign funds or institutional investors in private markets.[1]

Sovereign funds believe working with their peers improves performance and manages risk. “By collaborating with like-minded institutional investors – pooling resources, sharing expertise and transaction expenses, and exploiting local networks – we can potentially mitigate risks and improve returns,” said one sovereign fund. For example, they may have local market knowledge in domestic investments and provide value-added services that may improve the deal’s chances of being successful. But, as Professor Lerner points out, “Sometimes with multiple SWFs considering a deal at the same time can be a very drawn-out process.”

In some cases, cooperation meant investing alongside one another in deals. “We are never alone,” said one fund. “We don’t want to be alone. We are much more comfortable taking 20 per cent of a transaction than taking more of it. In most cases, we find ourselves in a consortium where you have other SWFs like us. We work together. We know each other. We have regular contact.”

In other cases, it meant simply “picking up the phone” occasionally to compare notes. “We like to know what peers are invested in a certain fund. If we see something that concerns us and want more information, it’s great to have other investors you can call up to share views and compare ideas,” said one fund. Comparing notes can also help sovereign funds improve internal best practices or validate their approach for stakeholders.

Sovereign wealth funds also stressed the importance of alignment of objectives when collaborating with one another. One sovereign wealth fund told us that “What we look at for in a particular investment may be different. Your counterpart may see it more as an equity investment, and might be willing to bid more. We have partners with whom we are comfortable working, but we are also comfortable being competitors at certain times.” Another said: “We have learned that although we may share a long-term horizon with our partner, our investment strategy or capability may differ widely. Finding a truly aligned partner can be difficult.”

To make partnerships successful, sovereign wealth funds stressed the importance of understanding fully the partner’s objectives (for example, whether purely financial or development focused), and communicating at the outset of an investment the timeframe, division of duties, costs, and division of fees. “To achieve successful outcomes, you have to understand the motivations of your partner,” said one such fund. “It is important to take the views of other partners and deal with them up front and define a clear objective as to what everyone is trying to achieve.” Equally, this fund said, that it is important to help partners achieve their goals. If these objectives change, then one party may have to compromise. For example, the fund explained that if a partner wanted to exit an investment, and this did not run counter to its own interests, that it would consider doing so if market conditions allowed.

---

[1] It is possible that this unanimous result is subject to selection bias insofar as sovereign wealth funds that are interested in cooperation were more likely to agree to speak with us for this project.