The challenges of private markets: a discussion with Professor Josh Lerner

Below, we present a summary of our discussion with Professor Josh Lerner, Jacob H. Schiff Professor of Investment Banking Unit Head, Entrepreneurial Management. Both the questions and answers have been edited for clarity.

Q: *It is a well-documented trend that SWFs and other institutional investors are increasing their investments in private markets, particularly private equity. What is driving this trend and what risks do you see for these investors?*

JL: It is natural for these institutions to want to go into private markets, which have historically offered attractive returns, to build their savings, especially in light of the lower returns in many stock and bond markets in recent years. But experiences have differed across funds. Performance of private markets has been very uneven. Endowments have historically done much better than pensions and SWFs. There are several reasons for this. First, there is a tendency for investors to jump in at the wrong times, to invest at market peaks. In all private markets, this is the worst possible strategy! These markets tend to exhibit a ‘boom-bust’ dynamic with tremendous variation in performance across vintage years. Second, in many cases, it also comes down to manager selection. In all private markets, there is huge disparity between good managers and not-so-good managers. The returns to choosing good managers are really quite high.

Q: *Are there any common factors you have observed among the most successful private markets investors?*

JL: We have interviewed some of the most successful long-run investors and asked them what made them so successful in terms of investing in private markets. One thing that is important is to cultivate a long-term time frame. 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. The most successful investors also tend to have a process for institutionalised learning. 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. They try to identify the features of successful teams and figure out how to incorporate those learnings into subsequent investment decisions.

Q: *What are the best practices for building a private markets investment capability at an SWF? What are minimum resources required and how does one identify an attractive investment manager or opportunity?*

JL: First of all, don't try to do it overnight! When we look at the performance of limited partner investors, we see a strong temporal trend. The longer you've had a private equity program, the better your returns. Private markets are not an area where you can just go from zero to 60 miles per hour overnight. You have to look at it as a longer run kind of process. Second, you really need to build relationships and understand the lay of the land. 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. The final thing has to do with the importance of 'stickiness' in having a team that is around for an extended period of time. This raises a couple of issues which are clearly difficult for all institutional investors whether they are SWFs, endowments, or pension funds. It has to do with what is required to create an organisation where people remain. It is partly to do with compensation. In the US pension system, for example, professionals are investing billions of dollars but often being paid only 50,000 or 60,000 USD per year. Eventually, they often get impatient and leave. But it also has to do with imbuing the organisation with a sense of mission. 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.

Q: *One of the challenges that SWFs frequently cite in building strong teams is location. They're often not based in financial centres. Is that an important factor?*

JL: It is a challenge. One approach we often see at SWFs is building groups composed of ex pats who come in for a couple of years and then leave. Even if they're terrific people, this strategy doesn't engender the continuity that these funds need. 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.

Q: *With respect to the importance of continuity of the staff, for many SWFs, compensation is a challenge. Media scrutiny and government constraints make it very difficult to be competitive. We need another incentive to attract people or sometimes we need to outsource. In light of these constraints for internal staff, sometimes it is easier to incentivise asset managers or outside companies. In a public entity, is the best strategy to raise internal comp or pursue other opportunities externally? Which is most efficient? How should we strike the right balance?*

JL: It is certainly an issue that many institutions have faced. Consider the comparison between Harvard's endowment and Yale's. Harvard had more in-house capabilities and paid higher salaries. As a result, it has been criticised for it by alumni and some others. But when you look at how much they are paying, even paying someone within an endowment several million a year to manage money is cheaper than paying an external manager to run the same fund. Fees to managers are invisible in a sense, because returns are reported on a net basis. Compensating staff appropriately is worthwhile. I realise it is politically difficult. We were just talking to a large pension fund. The people in charge of the private equity group, which has several billion in investments, indicated that their total annual travel budget for the group was $20,000 per year. This just seems crazy to me. If they spent $1 million on travel and got their performance up by 1 basis point it would be worth it many times over. But it was a political decision that the governor's office made. They didn't want employees going on "junkets" so they set a low travel budget. This highlights some of the challenges in this area.

Q: *I fully understand and agree with your arguments. But in an environment with media scrutiny, extensive disclosures, etc., people are reluctant to join a public organisation. Within that environment, in practice, I'm not sure compensation is the best approach. Are there more innovative ways to get access to that kind of talent?*

JL: It is clearly not all about the money. 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. In US pension funds, the mentality all too often is about controlling behaviour more than creating an environment where people feel like they're doing something very important for the place that they're representing. The worst case is a relatively poor compensation scheme and an environment that doesn't inspire people – then it can be a real challenge to retain personnel.

Q: *The long-term nature of private markets investments means they require more comprehensive governance. How do SWFs deal with that and what are issues that need to be addressed?*

JL: 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. On the other hand, when you look at some of the pensions for public employees, where you have non-investment professionals involved in making detailed decisions, it is not a formula that leads to great results. The best approach is to hire qualified people and give them the leeway to make investment decisions.

Q: *Another hot topic is fees and the high costs of retaining private equity managers.*

JL: This is a topic of enormous interest for LPs around the world. And it is reasonable to see why. If you look at fund structures with 'two and twenty' type compensation schemes, it is extremely generous. In many ways, it's surprising that fees haven't adjusted more over the last several decades. You could even argue that compensation for private equity managers has gone up, because the amount they manage has gone up so much and there are economies of scale in these funds. If you have the same fee level, and assets go up, the amount of compensation per partner increases dramatically. There are a variety of responses we've seen from LPs. One is shadow capital; separate accounts where LPs commit more assets in exchange for more favourable economics. We're also seeing more variability in funds in terms of fees that LPs are paying, even versus five years ago. LPs are negotiating side letters, so that the price that a given investor pays may be very different from the investor alongside of them. We're also seeing a lot of interest in direct investing. It is appealing and has potential for large cost savings. But if you look at the research, it is clear that direct investing considerably harder than first meets the eye.

Q: *That's a great segue to the topic of direct versus indirect investing. What are the key considerations an SWF should take into account when thinking about launching a direct investment programme? What are the benefits of direct investing?*

JL: There are two key benefits. 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 no fees (or with a substantially lower fees than fund investing), that is one benefit. You also control the timing of investment decisions: when to sell and when not to. You can hold the investment for 20 years if you want to. You're not married to a private equity group, with its own priorities and structure. The appeal is easy to see. The real question is whether performance is good enough that one ends up ahead of the curve.

Q: *Considering challenges of attracting staff, which we've already discussed at length, can SWFs expect to make investments of high enough quality to keep pace with fund investments?*

JL: To study this question, Lily Fang, Victoria Ivashina, and I looked at seven large institutions across the world: pensions, endowments, and SWFs who had all been doing private equity for a decade or more. They shared data on their direct deals with us. We put all data in blender, to keep the institutions anonymous, and looked at what the performance looked like for these investments. What we found is that by and large they did reasonably well, but not better than funds, even after the fee savings were taken into account. If they had invested in the average private equity fund, their net performance would have been pretty much the same. In terms of our conclusions, there were a couple of surprises and a couple things that weren't so surprising. It was less surprising that there was a big difference between venture capital and private equity. 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. It's hard to pull off. With private equity it is more straightforward: everyone is investing at the same time. These deals turned out to be more successful. The biggest surprise we found, which has since been corroborated by others, 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. The institutions in our sample tended to co-invest in large deals done at peaks in the market – venture capital in 1999 and buyout in 2007, for example. Few of these turned out to be successful. Interestingly, when it came to solo deals, the ones most successful were, for example, a Canadian fund investing in a Canadian deal, not necessarily a Canadian fund investing in Chinese deal. They did well investing in their 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. There is a challenge as to how much can you expand and have the same success.

Q: *This notion that local knowledge is important came up in many of our discussions with other SWFs. But, as you point out, some SWFs live in local markets that are very shallow in terms of their private equity opportunities. So they have to go abroad if they want to invest in this market. How can they overcome this challenge?*

JL: One area with increased interest is club deals, not between multiple private equity groups but between multiple SWFs. In these situations, if there is one group where the deal is in their backyard with an information advantage and an ability to provide value-added services, and the other institutions aren't local, the insiders can increase the probability that the deal with be successful. There have been a variety of efforts trying to encourage communication between SWFs and other large institutional investors. There have been a few deals done together. One challenge is that these institutions often find it hard to move quickly. Private equity fund managers, on the other hand, can move fast. Sometimes with multiple SWFs, considering a deal at the same time, it can be a very drawn-out process.

Q: *Is there a particular asset level or threshold that makes direct investing preferable to indirect investing?*

JL: I don't think there is a magic number. There is a number below which it doesn't make sense to direct invest. If it's less than a couple of billion dollars, it is hard to make a persuasive case that direct investing makes a lot of sense. There could be exceptions, for example, a family office investing in an industry where the founders have private knowledge. But for most small organisations, it doesn't make sense. Beyond that, it is hard to say. It has less to do with asset levels and more to do with the things we talked about early on: the skill set of the investment staff and how experienced are they in this area. It's also to do with having a governance process that supports this kind of activity. It's less a matter of dollars and cents and more about the decision making process within the organisation.

Q: *When it comes to selecting private equity managers, we've heard two arguments. One is that there are benefits to making large investments. The other is that you want to stay small. What does the research say on this question?*

JL: If you look across private equity funds, the very smallest funds do poorly. 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. When a fund does a very large transaction, for example a middle market group reaching into low-mega space, things don't turn out very well. Why is this? 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.

Q: *We'd also like to talk about private markets investments in a total portfolio context, alongside public markets investments. Given the limited track record for private markets, how should SWFs approach the process of establishing return and risk expectations?*

JL: This is a topic that is complicated and where there are no easy answers. It is also a very important topic to think about. There is a lot of research on private markets, what risk and return characteristics are, how they compare to public markets, and whether or not they outperform. The thing that makes performance hard to analyse is understanding what the risk is. When you look at private markets with no risk adjustment, you typically see outperformance. When it comes to risk adjusting, it gets quite challenging. Specifically, in the context of private equity, funds tend to be conservative in terms of valuations and mark the investment at cost for extended periods of time after the deal is done. As a result, when you look at the correlation between private and public markets, it often appears quite low. But you have to wonder: is it really that low or does it just reflect the fact that private equity investments aren't marked to market? Is the low correlation just reflecting the lag in valuation? The academic literature typically makes adjustments to the valuations of returns on a quarterly basis and tries to more accurately reflect what was going on in the portfolio. The problem is that the estimates of risk and correlation (with public markets) are very sensitive based on how you go about this process. Some papers say beta of private equity is about one and others say it is as large as three. You see everything in between. When you have wildly different estimates of risk, the risk-adjusted returns are therefore highly variable as well. There is also the complication of whether you make an adjustment for liquidity. These aren't easy investments to buy and sell. The literature shows that if you look across the NASDAQ, the stocks that trade less frequently offer an additional return, even if you adjust for their other characteristics. The truth is that we don't really know yet how to estimate return and risk for private markets. There is a lot of research on this question but it seems like we are at the same stage that we were with public markets back in the mid-1960s, when Sharpe, Lintner, and their colleagues published the CAPM. The notion of beta was out there, but it hadn't yet been put to work by mutual funds, hedge funds, and data services. It was an academic idea and the industry hadn't worked out how to put it into practice. A lot of tools developed by academics in recent years will be useful in answering this question about risk and return, but they aren't in a form yet where they are user-friendly for SWFs and other investors to put into practice.

Q: *Another practical issue for SWFs is the issue of identifying investment managers. Are there any manager characteristics that have been shown to be reliable predictors of skill?*

JL: The first ting to note is that there is huge variation across managers. If you look at interquartile range of manager performance — that is, the difference between the 75th and the 25th percentile manager — for public funds, it is around 3 percent, whereas with private equity it is closer to 15 percent. For venture capital, it is even larger at 20 percent. There is enormous variation in performance across managers. If you can chose top-quartile managers you do very well, even if private markets as a whole don't do spectacularly. The returns to manager selection are quite large. So, how do you pick good managers? If I knew that answer to that question, I would be a billionaire myself! You can point to some patterns in the data. For one, performance is sticky. If a manager performed well in past, they are likely to perform well in the future. This is where private equity and real estate are different from public markets. With mutual funds, there is almost no persistence in manager performance from quarter to quarter. Even among hedge funds, where there are rocket scientists and secret formulas, there is remarkably little persistence in over longer time frames. That's one pattern, though research by Steve Kaplan and co-authors suggests that persistence may be weakening over time. Another pattern has to do with the size of the funds. Not so much that large or mid-size funds do poorly, but rather that rapid growth seems to be associated with a deterioration of performance. Private equity firms that increase fund size very rapidly seem to suffer in terms of their returns going forward. The thinking is that partners end up trying to do too much and that ends up cutting into their performance. Finally, there is lots of evidence to suggest that specialisation is a good thing in private markets. If you look at health care, technology, or financial services sectors, the funds that are specialists tend to do better than the funds that are 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.

Q: *Does that last point about specialisation work against fund of funds?*

JL: It does suggest that rather than a one-size-fits-all fund, you want to look at the specialist firms. Find someone who is doing real estate in India or Scandinavian corporate finance.

Q: *Continuing on the topic of manager performance, one of the key challenges is how to benchmark managers. There are few benchmarks and they have limitations. Can you provide any insights in how to evaluate private markets investments over time when you don't necessarily have the best benchmarks available?*

JL: This is certainly a challenge. Part of it is that there are relatively few benchmarks and there are big differences across the benchmarks. It is hard to know why the differences exist and what is behind it. One approach that I recommend to SWFs and other investors is to carefully evaluate your performance across multiple benchmarks. Instead of using one benchmark, have a "big tent" approach with multiple indicators of market activity. Drill down against each of these. One may look better than the other, but looking at multiple benchmarks will give you the best overall sense of how well you are doing.

Q: *Earlier, you suggested that one characteristic of successful private equity investors is a commitment to institutionalised learning. What sort of processes have you observed? How was this implemented?*

JL: This is done in a variety of ways. There isn't one magic formula. You see some groups implementing a process where they sit down every year and evaluate the performance of a given asset class. They may rotate through private markets, from one to the other. This could be just the staff or also include members of the investment committee as well. In some cases, that group goes back to the original investment memoranda and asks themselves some questions. What did we get right? What did we get wrong? This isn't done in the spirit of apportioning blame. It is more about how they can learn from their experiences. One of the things that everyone would agree is that investing in private markets is not a purely analytical process. 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.

Q: *We have focused on private markets in this discussion. Obviously, public markets also comprise a big part of any SWF portfolio. What are the best approaches for evaluating private markets opportunities in the context of the broader portfolio?*

JL: Institutions have a variety of approaches. We have done a series of case studies on one institution that has an extremely analytic approach where they use a large matrix, based on industry and country, to determine how much equity they will invest in each cell. When one of their private markets fund invests in a company in a particular country, they sell the corresponding amount of public equity from that cell to keep the total exposure to that country/industry in balance. That’s an extreme form. Other groups have targets in terms of allocations to keep things in balance.