The Rise of the Asset Owner-Investor in Private Markets

A workshop hosted by the Private Capital Project at the Harvard Business School
and the Private Capital Research Institute

On October 11, 2019, a group of limited partners ("LPs"), academics, and general partners ("GPs") met at the Harvard Business School to share perspectives on the rise of the asset owner-investor in private markets. The past decade has seen an extraordinary surge of interest in the part of asset owners—including pensions, sovereign wealth funds, and family offices—in direct private market investments. Having started with traditional funds to build their initial exposure to the asset class, they are now eager to expand their own capabilities to co-invest alongside their private equity managers, or even lead deals themselves.

The motivations driving asset owners to seek more control in their private equity investing activities are multiple, but include a desire to avoid the fees charged by traditional partnerships, the belief that their long-run time horizons will facilitate the identification of attractive investment opportunities, and the quest to manage the assets in their portfolios better. At the same time, these investment strategies can be difficult for asset owners to execute. In particular, these organizations must build up their underwriting capabilities and deal flow over time. Recruiting and retaining experienced staff can be a challenge for non-profit and governmental organizations. In addition, evaluating these investments in an effective and objective manner is challenging. This workshop—drawing together leading asset owners, general partners, and academics—explored this important and fascinating territory.

General Partner Perspective

John Haggerty, Managing Principal, Meketa Investment Group, led a panel discussion on the rise of the asset owner-investor in private markets with a group of prominent general partners. Discussants included Brian Conway, Chairman, Managing Partner, TA Associates; Mark Gallogly, Co-Founder and Managing Principal, Centerbridge Partners; Scott Sperling, Co-President, Thomas H. Lee Partners; and Glenn Youngkin, Co-CEO, The Carlyle Group.

Over the past decade, there has been a surge of interest in investment vehicles other than traditional funds, such as co-investments and solo investing, within the private equity (PE) industry. Moderator John Haggerty led this distinguished panel of GPs to discuss their insights on and experiences with these newer investment strategies.

In this discussion, the panelists reaffirmed the increasing popularity of co-investing and other alternative investment vehicles. What is driving this demand? The immediate response from the panel was that co-investing lowers fees. Co-investing also provides opportunities to accelerate investment pace and mitigate the "J-curve effect" (that is, the tendency of portfolios to yield positive cash flows and returns only after a number of years.)

Co-investments can benefit GPs as well. First, co-investing allows GPs to "flex up" for larger transactions than they could fund alone. Notwithstanding the financial incentives, the panelists explained that GPs are also attracted to co-investing because it promotes a better understanding about how each party approaches investments, building ties between LPs and GPs. In addition, LPs may have relationships or geographic proximity that make their capital strategic in certain transactions, as well as providing unique perspectives, knowledge, and insights. Finally, through co-investing, GPs obtain more flexibility, which can result in a superior portfolio. Thus, co-investing has the potential to deepen the GP-LP relationship.

While the GPs stressed that their primary concern is to invest a fund well, the panelists shared opinions as to which characteristics they found attractive in a co-investment partner. Such attributes, the panelists explained, are somewhat dependent on the situation. As a case in point, if the fund can only finance a modest portion of a transaction, a partner that is willing to work "shoulder-to-shoulder," to live with the expenses of a potential broken deal, and to engage with the company is important to have. In this instance, a desirable co-investment partner would be one that is experienced and heavily staffed. When there is a moderate amount left over after the fund investment, preferred qualities of a potential co-investment include responsiveness and decisiveness.

Although many are quick to note the benefits of co-investing, the panelists cautioned that potential risks and challenges might arise. First, if there is not clear communication between the GP and the LP concerning the expectations of the GP and the actions of the LP, frustration may ensue on both ends. Therefore, to ensure a healthy GP-LP relationship, the panelists felt that transparency is essential. Second, contrary to popular belief, the running of an efficient co-investment program is not easy. Regulatory, tax, and management challenges can trip up LPs and GPs alike.

As the discussion came to a close, the panelists addressed several questions. One related to the issue was how early to bring in co-invest partners, given the high mortality rate of potential transactions. Another critical issue was adverse selection risk. Because co-investments result in reduced fees, it might seem reasonable to assume that the more co-investment a GP offers, then the lower the quality the GP must be. The panelists felt this conclusion was overly simplistic. First, the engagement of LPs in co-investments leads to unique and proprietary investment opportunities for some GPs. The investments allowed groups to grow their portfolios without facing the challenges sometimes associated with rapid increase in fund size. Reputational considerations also provided an important check on opportunistic behavior. “You don’t want to disappoint you customers,” a panelist noted. That said, the GPs agreed that the responsibilities of managing co-investments are significant and can lead to distractions, especially given the heterogeneous nature of the potential partners.

In short, the panelists concurred that by enabling new deals, providing high returns, and sometimes enriching the ability to add value to portfolio firms, co-investing has become a mainstay of the PE industry. Not only has co-investment proven beneficial to LPs by helping them get closer to their managers and create portfolios tailored to the exposures they most desire, but it has also advantaged GPs.

Academic Perspective

Josh Lerner from the Harvard Business School led a panel discussion on some findings about co-investments and solo investments with a group of academics. Discussants included Victoria Ivashina, Lovett-Learned Professor of Business Administration, Harvard Business School and Tim Jenkinson, Professor of Finance, Saïd Business School, University of Oxford.

Josh Lerner began by broadly highlighting the challenges of doing research on private equity performance. Much work has focused on the assessment of the returns generated by private equity main funds, in large part because that was where data were more readily available. What really should be assessed, however, is the entire economic relationship between GPs and LPs, which includes co-investments and solo investments of LPs. Since we are in the early stages of getting these data, Lerner explained that researchers have had to go outside of traditional information sources. In this panel, Lerner led a discussion on the latest academic research on alternative investment vehicles.

Victoria Ivashina from the Harvard Business School began by summarizing her research[1] (conducted with Lily Fang and Josh Lerner) on the performance of co-investments and solo investments as compared to main funds. Using data spanning 20 years from seven large LPs, Ivashina shared her finding that realized returns (after fees) on private equity main funds was 8% better than the performance of co-investments and solo investments undertaken by LPs. As a caveat, Ivashina mentioned that this study focused on investments made largely before the Global Financial Crisis, when co-investment was a more narrowly focused LP strategy.

Ivashina also put the rise of co-investment transactions into context, highlighting the upsizing of allocations into alternative investments (which includes private equity, private debt, real estate, hedge funds, infrastructure, and natural resources) by public and private pension funds.[2] Using data collected from 2,000 pension funds from around the world over a 10-year period ending in 2017, Ivashina and Lerner confirmed the aggressive shift to alternative investments by pension asset owners. These results are consistent across both developed and emerging markets, funds of all sizes, and both public and private funds. Ivashina explained that this result could be partially explained by the low interest-rate environment. To illustrate, **Chart 1** shows that from 2008 to 2017, over 2,000 pension funds from around the world substantially increased their allocation to alternative asset classes, increasing their allocations as a percentage of AUM by nearly five percentage points on average.

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[1] Fang, Lily, Victoria Ivashina, and Josh Lerner, "The Disintermediation of Financial Markets: Direct Investing in Private Equity," *Journal of Financial Economics*, 2015.

[2] Ivashina, Victoria and Josh Lerner, *Patient Capital: The Challenges & Promises of Long-Term Investing,* Princeton University Press, 2019.

Chart 1

Alts Allocation by Fund Size, 2008 and 2017

Size percentile	Mean 2008 AUM ($ billion)	Alts holdings (% of AUM) 2008		Alts holdings (% of AUM) 2017		Diff. (2017-2008)	
1	0.049	2.76		9.27		6.50	***
2	0.153	3.04		11.95		8.91	***
3	0.328	5.57		9.93		4.36	***
4	0.576	7.10		10.92		3.81	***
5	0.913	5.16		11.77		6.61	***
6	1.400	7.49		12.28		4.79	***
7	2.136	8.21		12.58		4.37	***
8	3.613	6.41		12.97		6.56	***
9	7.463	7.21		13.11		5.90	***
10	56.365	9.57		13.16		3.59	***
Diff.	(10) - (1)	6.81	***	3.90	***		

Source: Ivashina presentation October 11, 2019 at The Rise of the Asset Owner-Investor in Private Markets Workshop at the Harvard Business School.

Next, Tim Jenkinson of Saïd Business School, Oxford University shared his research[3] on the performance of co-investments in private equity. In his study, with co-authors from Technical University Munich, Jenkinson examined returns at the deal-level for about 20,000 buyout and venture capital transactions, of which just over 1,000 were offered for co-investment. By examining the distribution of returns within a fund, Jenkinson found that most buyout funds are characterized by a few really successful deals (a public market equivalent, or PME, of about six, where one represents a case where the private return and the public benchmark are equivalent), resulting in a highly skewed distribution. Only 35% of deals within a fund outperform the corresponding overall fund return. Furthermore, Jenkinson shared that this skewed distribution of gross return is similar for both deals where there are and are not co-investments (see **Figure 1**.)

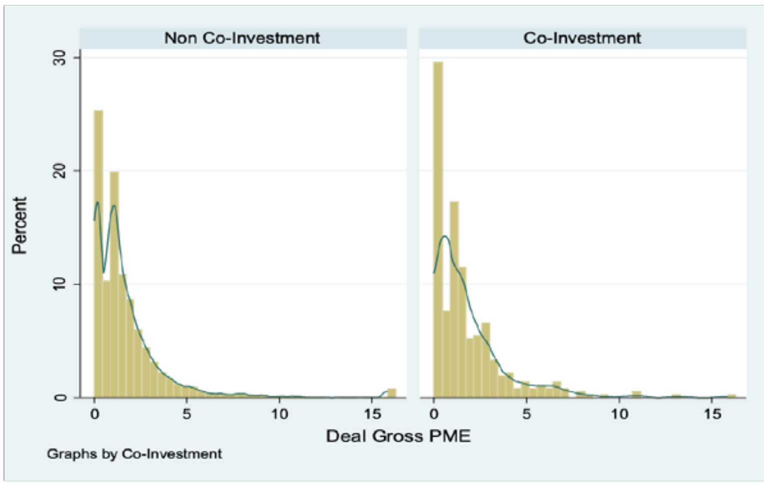
As investors ultimately care about net returns, Jenkinson provided facts in **Chart 2** about net returns based on three kinds of hypothetical fee structures: no fees, 1/10 and 0/20. Not surprisingly, since gross returns are similar for co-investments and funds, by investing at lower fees, co-investments have better net returns. With the no fee structure, the difference in returns between funds and co-investments is statistically significant: about 0.30 - 0.40 greater PMEs (translating to about 30-40% higher returns). The difference in returns is only somewhat statistically significantly different when using the 1/10 and 0/20 fee structures.

Figure 2 provides further evidence of the superior return performance of co-investments. In this figure, the bubble size represents the numbers of co-investments in those years. It is obvious that the majority of the bubbles are above the zero level, which means in

[3] Braun, Reiner, Tim Jenkinson, and Christoph Schemmerl, "Adverse Selection and the Performance of Private Equity Co-investments," *Journal of Financial Economics*, forthcoming.

those years co-investment returns beat fund returns. For those years with inferior performance by co-investments, Jenkinson stated that the reason could be the large amount of money invested in some poor performing deals. Given these results and the skewed distribution of the co-investment returns, Jenkinson concluded that a good strategy might be co-investing in scale, leading to an increase in the number of winners and thus increased returns.

Figure 1
Distribution of Returns of Individual Investments within a Fund
Gross Returns



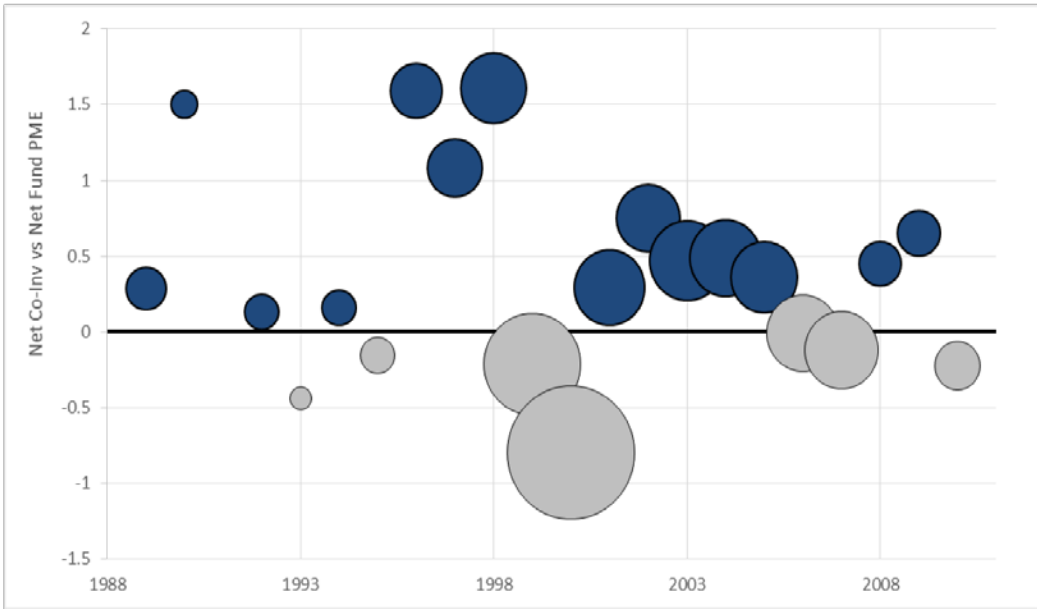
Source: Jenkinson presentation October 11, 2019 at The Rise of the Asset Owner-Investor in Private Markets Workshop at the Harvard Business School.

Chart 2
Net Performance of Co-investments

	PME					
	1. Buyout			**2. Venture Capital**		
SCENARIOS:	Obs.	Net	Net-Net	Obs.	Net	Net-Net
A. Funds:	246	1.36	1.35	218	1.29	1.28
B. Co-Investments:						
No Fees	365	1.76 ***	1.71 ***	651	1.55 ***	1.51 ***
1/10	365	1.59 ***	1.54 ***	651	1.38	1.33
0/20	365	1.56 ***	1.51 **	651	1.34	1.30
C. Co-Investment minus Fund:						
No Fees	365	0.34 ***	0.29 ***	651	0.43 ***	0.39 ***
1/10	365	0.18 **	0.13 **	651	0.26 ***	0.23 ***
0/20	365	0.15 **	0.10 *	651	0.23 ***	0.19 ***

Source: Jenkinson presentation October 11, 2019 at The Rise of the Asset Owner-Investor in Private Markets Workshop at the Harvard Business School. Net-net returns refer to returns after the estimated annual cost of managing the investment program.

Figure 2
Co-investments vs. Fund Returns by Vintage



Source: Jenkinson presentation October 11, 2019 at The Rise of the Asset Owner-Investor in Private Markets workshop at the Harvard Business School.

In the final presentation, Josh Lerner shared his research conducted with Jason Mao (State Street), Antoinette Schoar (MIT), and Nan Zhang (State Street) on alternative investment vehicles ("AIVs") in private equity investments, including co-investments, special purpose vehicles and other non-traditional structures. In this very recent study, Lerner and his colleagues examine the use of AIVs in private equity over four decades. In **Figure 3**, Lerner pointed out that from the 1980s to 2017, the share of AIVs increased from about 2% in the 1980s to nearly 40% in 2017.[4]

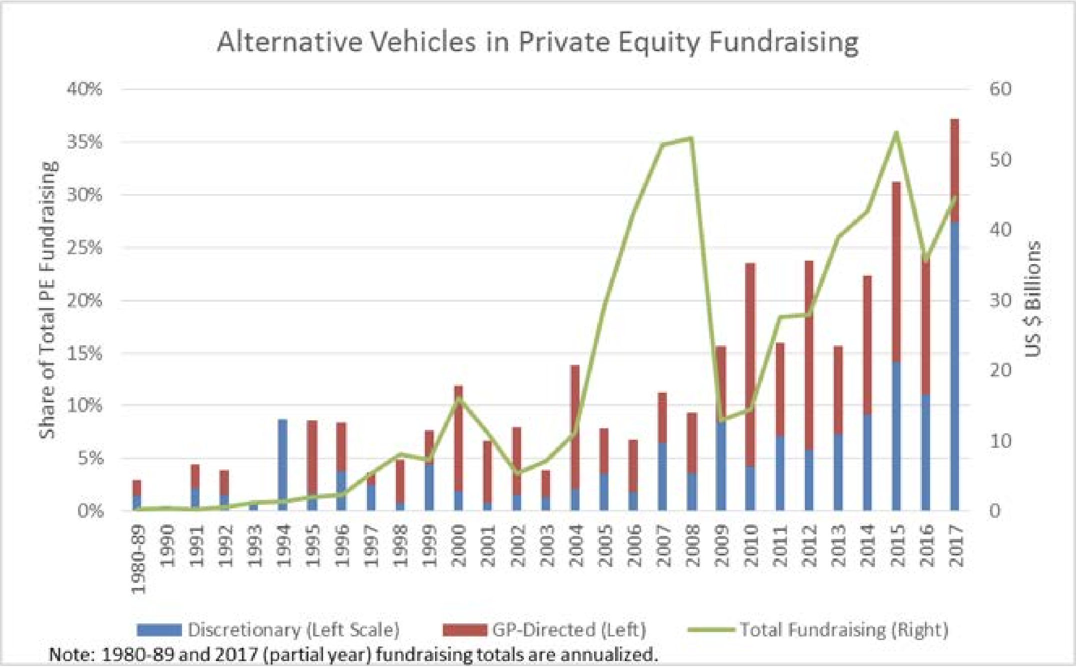
Next, Lerner shared results on the relative performance of AIVs and the associated main funds as measured by PME, net of fees. When looking at the entire period from 1980-2017, the weighted average PME of AIVs was much lower than the associated main fund, by about 13.8% (see **Chart 3**). This finding is consistent with his and Ivashina's previous result. However, Lerner explained that a few large negative investments drove much of this pattern. Furthermore, when just focusing on more modern deals from the post-crisis period from 2009-2014, Lerner showed that AIVs actually outperform the associated main fund by almost 7%–a result more consistent with Jenkinson's findings. Having reconciled the contradictory results, Lerner explained that this seems to illustrate that there may be a secular change over time–not just more money in AIVs, but perhaps performance improvement as well.

Lastly, Lerner explained that the best relative performance in AIVs was concentrated in endowments and foundations, mid-sized asset owners, Europe-based organizations,

[4] Lerner, Josh, Jason Mao, Antoinette Schoar, and Nan R. Zhang, "Investing Outside the Box: Evidence from Alternative Vehicles in Private Equity," Harvard Business School Entrepreneurial Management Working Paper No. 19-012, 2019.

and in LPs with historically high performance in terms of their fund. The poorest performance of AIVs were concentrated in the LPs with the poorest performance in the main fund. Lerner concluded by saying these results highlight the fact that there is a lot of heterogeneity across deals and LPs and that this carries over to AIVs as well. Thus, Lerner cautioned against viewing co-investments and related investments as a "one size fits all" solution.

Figure 3



Source: Lerner presentation October 11, 2019 at The Rise of the Asset Owner-Investor in Private Markets Workshop at the Harvard Business School.

Chart 3

Alternative Vehicles Relative Performance Relative to Main funds

Vehicle type	N	Weighted average	p-value	Median
1990-2017	1433	-13.8%	0.001	-0.2%
2009-2014	791	+6.98%	0.011	1.3%

Source: Lerner presentation October 11, 2019 at The Rise of the Asset Owner-Investor in Private Markets Workshop at the Harvard Business School.

Limited Partner Perspective

Guthrie Stewart of PSP Investments led a panel discussion on the Rise of the Asset Owner-Investor in Private Markets with a group of leading LPs. Discussants included Ted Eliopoulos, Morgan Stanley Investment Management; Susanne Forsingdal, Allianz Capital Partners; Rick Slocum, Harvard Management Company; and Brad Thawley, UTIMCO.

While the degree of co-investing and solo investing in private equity has varied significantly from LP to LP over the past several years, it is clear that these strategies are becoming a mainstay of investing. Perhaps what has contributed most to this phenomenon is the fact that these strategies recently have performed better on a net-of-fee-basis. In this panel discussion, Guthrie Stewart led a distinguished group of current and former LPs to discuss the evolution of co-investing and solo investing as well as the challenges and benefits.

The LP panelists began by agreeing with the GP panelists that lower fees was not the sole driver of their desire for more co-investments. Forming strong relationships with their GPs and developing their own internal talent were equally important. Furthermore, they also strategically use co-investments to make quick adjustments to their portfolios in situations where they are underweighted in certain attributes (e.g., sector or geographic). Lastly, the panelists noted that co-investments expand the availability of opportunities providing for greater diversification across more transactions.

Still, many LPs choose not to limit themselves to only investing alongside GPs and prefer to make solo investments, even though this can be a more demanding endeavor. By writing large checks alongside GPs, many LPs maintain greater control. However, the panelists pointed out that starting a solo investment program has significant hurdles, especially for public pension funds and non-profits like endowments. Most often, there are significant governance issues that create organizational challenges, which may result in political and policy push back. Moreover, there are compensation issues associated with experienced direct investment teams that make it difficult to attract and keep talent. One way around these problems is to set up special vehicles from which to deploy direct and co-investment capital, but care must be taken not to compete with their general partners, as well as to maintain a separate, independent entity.

Next, the panelists discussed issues around the balance between selecting the best managers and access to co-investing opportunities. The panelists agreed that finding a good GP is more critical than whether or not there would be co-investment opportunities offered. Having relationships with great GPs is ultimately what is of most value. Some LPs, however, will fund GPs with below-median performance if offered more co-investment opportunities.

In general, the panelists agreed that most LPs do not simply accept all co-investment opportunities offered, but perform some level of due diligence before making a determination to go forward or not. It was suggested that perhaps it may be better to just take every co-investment deal rather than trying to cherry pick transactions with limited time, insight, and resources. Overall, the panelists felt that trust in the manager was the most material factor in weighing co-invest opportunities and that trying to second-guess their GP partners was unlikely to be productive.

A serious challenge with co-investments and solo investments is setting the appropriate compensation for the internal managers at the asset owners. The panelists agreed that compensation of the private markets team should be the same, regardless of whether they are investing in main funds or co-investments to avoid misaligned incentives. Having separate compensation schemes could drive managers to do more regular fund investments than co-investments or (more frequently) *vice versa*.

For solo investments, the LPs explained that it is difficult to have competitive compensation in the US because of public scrutiny, especially for public pension funds and non-profits. On the other hand, in Canada, where there is less regulatory scrutiny, some LPs have found a way to offer reasonably competitive compensation and have grown their solo investment programs. Even if LPs could offer the right compensation scheme in the US, it could still be difficult to find talent who would want to work in the politicalized environment that many US LPs face. As mentioned above, these problems can be partially ameliorated with a captive independent separate special vehicle.

Finally, the panelists discussed the challenge of properly measuring success of co-investments. One crucial challenge is defining the specific time horizon, given that these investments are so long-term in nature. Next, it is important to figure out an appropriate benchmark. It was suggested that co-investments could be measured with a variety of yardsticks: an index of the performance of all co-investment opportunities, of only those co-investments that were not selected, or of all PE fund investments. Ultimately, the panelists agreed that the most appropriate benchmark would likely be a balanced mix of all three.

Despite real issues with co-investments and solo investments, the panelists agreed that the advantages of these strategies likely outweigh the challenges. As a result, the expectation is that co-investments and solo investments will continue to ramp up in the years to come.