Grappling the fund management problem

Many European institutional investors arrived on the private equity scene alongside an explosion of fund raising activity globally. In Europe alone EVCA figures show a jump from just over €20bn funds raised in 1998 to €48bn in 2000. This happened at a time when the only way for returns appeared to be up, but it also coincided with European private equity firms jumping in number from around 300 in 1998 to around 1,000 in 2000. Finding firms to invest capital with was not a problem for institutional investors, and while the returns won't be all that was promised, in part because some of the new entrants never made the grade, for many institutions what they are now grappling with is how to effectively manage these programmes that they jumped into with such gusto. *Lisa Bushrod reports*.

Investing in private equity is a confusing business, particularly compared to investing in other asset classes. There is patchy information about private equity funds and their performance and what is publicly available is disclosed on a non-disaggregated basis, which means that, for example, while US venture funds may have an aggregated average return of X% the range within which US venture returns fall may be X-60% to X+60%. Finding the latter funds for institutions new to private equity can be difficult, particularly since it's not clear how many, by number, of funds are at or near to the X+60% point. This is because when non-disaggregated performance figures talk about quartiles of performance (bottom, third quartile, second quartile and top quartile) those quartiles are made up of value points, which means there are not the same number of funds in each quartile. So, worst-case scenario, the number of funds in the top quartile is a fraction of the size of those in the other quartiles, meaning tracking down the best performing funds can be like looking for a needle in a haystack.

Size of programme

One area where everyone appears to converge is the size of allocation to private equity. Though in real terms this can range from €5m to €1bn+, it is the percentage of the total asset pool on which everyone is focused. "We would say if you want to go into private equity [the investor] should be aiming for at least 5%, and if you want to get 5% over commit to the extent of 50% i.e. you need to commit 7.5% to get 5% actively invested," says Geoff Singleton at consultancy firm Hyman Robertson.

Wayne Harber at Hamilton Lane, the adviser and fund manager, underscores the relationship to overall fund performance: "It's not worth coming into the asset class for allocations of less than 3%. With a 3% to 10% allocation it is worth looking at private equity. Otherwise it's not going to affect the [whole fund] returns, even if the private equity returns are phenomenal."

Institutions usually get to the chosen allocation percentage over a period of time, primarily because it takes a long time to formulate a credible private equity programme but also because successful private equity investing is in part about getting the diversification level right. Diversification comes in many forms but one of the primary ones, which many institutions overlooked during the rapid deployment of capital during the technology bubble (1998 to 2000), is diversification by vintage year. As such a credible private equity programme tends to either involve buying into secondary funds, which contain older vintage funds, or deploying capital steadily over time. Even then the amount committed is not drawn down and invested immediately, as Singleton pointed out.

Swedish pension fund AP7 has an innovative approach to the problem of achieving diversity and reaching optimal allocation, including draw downs, immediately, however. Daniel Barr at AP7 explains: "Since we are quite a newly established fund the yearly inflow into the fund is quite large compared to the assets under management, so we could commit 4% of the inflow from the start and reach vintage year diversification by committing from future inflows. We also set up a parallel programme of listed PE funds. We have a portfolio of eight different funds listed in London and Zurich, both as long term investment to add up to 4% but also to work as holding place until our unlisted commitments are drawn down. These vehicles fall outside the regulatory restriction. [Only 10% can be committed to PE.] This would also give us some ability to rebalance through the public markets if needed. We will in normal instances not be forced to liquidate this portfolio since we grow rapidly over time even if the holdings are reducing as a percentage of the portfolio over time."

John Hess at advisory firm Altius Associates offers a wry insight on the issue of allocation: "Private equity is very difficult to model because there is no public data. So you end up with a bit of a fudge. Working backwards from the asset liability model if you put in a percentage for private equity, if the overall return is X you are looking at private equity giving you +200 to 400 basis points. That approach won't let you put any more. If you put in the 15% return you would expect from private equity the asset liability model would let you put 80% of your portfolio in private equity!" As he points out, with a return of just +200 to 400 basis points, no one would invest in private equity, given its risk profile.

Ways into private equity

Faced with the relatively opaque private equity market, institutions that have decided to embrace the private equity asset class must decide whether to adopt a do-it-yourself (D-I-Y) approach, outsource or embrace a combination of the two approaches. Wholesale outsourcing can involve placing capital with a manager either in a co-mingled account or a separate account. Co-mingled simply means two or more institutions investing with that manager will be lumped together in a group and share the same asset allocations, which will be defined by their pre-agreed preferences that include things like socially responsible investment as well as risk and return profiles.

The idea is that a co-mingled fund-of-funds allows the institutions involved more discretion than they would receive from a straight forward fund-of-funds structure, which is where the manager typically sets the investment criteria and retains a significant degree of discretion over which funds it commits to. All of this is decided

before the fund-of-funds manager goes into the market to raise capital so there is little opportunity for institutions to have an impact, beyond side agreements alluding to things like opt outs.

The separate account route is only open to those with a minimum of $50m to commit over a two- to three-year period, although the typical size of a separate account rests between $100m and $200m. Separate accounts are by far the most flexible fund-of-funds-style route for institutions in that they can allow the institution to retain total control of the asset allocation strategy, including rights of veto over GP selections suggested by the manager. This doesn't amount to wholesale D-I-Y though because the manager or adviser running a separate account retains responsibility for everything from performing capital calls to returning distributions, renegotiation of fees and dealing with offshore structure issues.

Neither is the advisor option necessarily a wholesale D-I-Y approach. While an advisor will advise the institution seeking to invest they may also provide a range of monitoring services, which includes all the things like performing capital calls and so forth mentioned above. Consultants, however, may be more hands-off, such as Hyman Robertson, for example, which only recommends fund-of-funds to its clients and the fund-of-funds covers all of those monitoring jobs because annual management fee pays it to do so.

The decision will largely be determined by the institution's house style, constraints and eventual programme size, as well as its understanding of private equity. Of course that assumes perfect pre-planning and fails to take account of the pressures caused by the evolution of a private equity programme and changes in the investing institution, not to mention the rapid entry many institutions made into the asset class during the 1998 to 2000 bubble. Sometimes, with a view of little more than a need to get a slice of the action, these 1998 to 2000 era programmes were ill designed, either in terms of their allocations or the resources allocated to get them underway. "Institutions have realised that it takes quite some infrastructure to do private equity in-house; the downturn has unveiled the complexities of the asset class," says Dr Stefan Hepp at SCM Strategic Capital Management.

Perhaps most alarming though is that institutional investors can find the private equity market so opaque that they are not even fully aware of all of these potential options. "Some investors like to start off in this asset class with a fund-of-funds or look to us to get access to parts of the private equity market that would be difficult to access otherwise. Many don't understand that you can do your own programme on a reasonably small amount of capital to put out and they don't understand how expensive a fund-of-funds is," says Hess.

Although the decision as regards which avenue an institution will pursue will be determined by house style, constraints and eventual programme size and its understanding of private equity, often there are more subtle pressures at work. "Very few asset managers at pension funds are on any sort of performance or incentive-based pay. So what's in it for them for taking big risks?" says Hess.

The issue of performance-related pay affects the investment decisions taken in more subtle ways. Not only is less risk more attractive since there is nothing beyond a 'thank you' for phenomenal performance and the potential to lose your job if things don't go well, but it can affect the avenue taken.

Geoff Singleton at Hyman Robertson explains: "Fund-of-funds is our preferred route for clients going into private equity. Basically we think the other routes are too difficult. First of all they have got to find someone to do it for them internally and as soon as they have learnt the business someone in private equity will come along and offer them a job and the investor will be back to square one." Singleton is referring specifically to public sector pension funds, with which he mostly works.

Where LPs currently stand

"Currently new investors decide that they are going to go into private equity and they will split the private equity exposure into pots: European large cap, European small cap, European venture, US large cap, US small cap, US venture, and others. They will then choose different experts for those pockets that they don't do themselves. The process to start a programme can take up to two years," says Mounir Guen at placement agent MVision.

Typically, his experience, as one that raises funds on behalf of private equity and venture capital firms, suggests those that have chosen to go the in-house route will pull more of their programme in-house over time as they gain experience and their confidence grows. But equally many attempt to undertake some of these programmes themselves and encounter difficulties. Hess says: "In Europe we see LPs that think they might need a bit of help to get up to speed in certain parts of the market where they have tried to get in unsuccessfully. Typically that is US venture capital or US middle market; US venture capital access is a huge issue today and in the mid market knowing who the people are is the issue, access is not."

The universe of institutions and consequently their approaches vary a great deal. Hess says: "In Europe in particular if the board or the trustees [of a pension fund] fully understand what you are trying to do with your programme then it's much easier to implement changes that may be a little bit racier. In my experience too few of them ever do then, if something goes wrong, and the board does not really understand what's happening the reaction is going to be pretty severe. People think [private equity] is fun; a lot more interesting than monitoring an index. People tend to get involved, whether have the knowledge to do so or not. Sometimes it's safer to have all decisions made outside your organisation."

Having decided it did not have the appetite to build an in-house resource, Swedish pension fund AP7 employed an independent adviser, which it used to screen potential investment vehicles, in its case fund-of-funds managers. Barr says: "We carried out quite an extensive tender process comprising 80 fund-of-funds managers. We used a consultant to go through the material and provided us with a short list. When we interviewed them we looked at the organisation, the people, the investment process, the portfolios and due diligence process and their past track record. And we had a number of specific requirements like to have at least quarterly NAV with monthly estimates and we have an SRI (socially responsible investments) policy we wanted managers to use their best efforts to implement."

Singleton is a proponent of the globally balanced approach, believing returns are optimised from the right mix of US and European buyout and venture funds plus other situations where appropriate. This limits the universe of fund-of-funds Hyman Robertson is willing to tap into more considerably than one might imagine given the proliferation of fund-of-funds managers in recent years. Many fund-of-funds focus only on one continent or commit some 70% to 80% to only buyouts or only venture. This causes diversification problems if an investor commits to three fund-of-funds with a buyout focus that each includes an allocation to one or more of the same buyout funds. "[Fund-of-funds] fees are expensive, but I think the bigger problem is the way pension funds appoint a single fund-of-funds manager," says Singleton.

Fund-of-funds

The fund-of-funds sector has had a bad press of late because fees, which are laid over those already charged by the funds in which they invest, are high and returns not as promised. An annual management fee in the region of 0.8% and 10% carry [the fund-of-funds manager's share of the profits] were the norm five years ago, but downward pressure means the management fee today more likely to be 0.7% and carry 5%.

Unfortunately, it's difficult to get any hard and fast figures on the performance of fund-of-funds. They covet their performance data, but the adage 'no news is good news' simply cannot be true when a fund manager, entrusted with millions or billions, refuses to release data, even on a non-disaggregated basis, that would allow it to be benchmarked. This intransigence is across the board in Europe, bar literally a handful of exceptions, and it makes fund-of-funds the only significant subset of the private equity class, by volume and by number, which does not provide aggregated performance data.

"The proliferation in fund-of-funds is to do with the fact that the industry is immature. Eight years ago private equity was the Wild West investment category. If you are in a market that is immature potential clients are early in their learning curve so the barriers to entry are quite low. Then if you have a boom like in the late 1990s it opens the doors to a lot of new comers," says Hepp.

Like the rest of the private equity market, the fund-of-funds segment is suffering from new entrants that never made the grade, although the feeling is that it is probably three to five years before it will be clear who the winners and losers are. Those managers that don't make it won't be able to build the critical mass required. Hepp says: "Roddy Swire [of fund-of-funds manager Pantheon] has said he believes a [fund-of-funds] organisation with below €1bn assets under management is not viable. I would agree with him. There is a constant need to improve systems and to pay good people. All that costs serious money." It's not surprising then that the fund-of-funds industry is under fire. With a big question mark over its performance, which is not likely to go away for the next three or more years, many institutional investors are left wondering quite what will happen if the firms looking after their capital are not destined to survive. Ultimately the younger team members leave and this will leave a skeletal staff or one with so much turn over that little knowledge is built up in the business.

But the picture for even moderately successful fund-of-funds managers is pretty rosy. "Manager selection risk is extremely high and that forces you to diversify. A lot of people can't [diversify] directly so fund-of-funds will thrive," says Hepp. But he shoots down in flames the two unique selling points behind which many fund-of-funds hawk their wares. "Most funds are happy to take quality LPs on board; access is nonsense and top quartile is nonsense," he says.

Cost

Hepp says: "A hot topic at the moment is the question of fees and value for money; what do you pay to get into private equity and is it worth what you pay?" The costs of fund-of-funds, although reducing, is far in excess of what consultants or advisers charge. However, consultant and advisers' charges are much more fluid and relate to fees charged in connection with the number of commitments that are monitored and the level of due diligence undertaken. This means smaller programmes with a large number of commitments end up paying more than a large programme with a smaller number of commitments.

Overall the feeling is that there is a growing interest in committing capital to the private equity asset class, which, despite the lacklustre performance of the asset class of late, is driven by long term performance enhancement considerations rather than government pressure or regulatory issues. Current workload of advisers and consultants is as much driven by the need of institutions to begin new programmes as it is to sort out existing programmes, which can involve pure advisory issues to the need to outsource day-to-day management when the infrastructure demands have become clear as the programme has gathered steam.

Although they are coming from different perspectives, the advisers do have an open dialogue with the traditional fund-of-funds managers not least because from time to time the advisers recommend fund-of-funds managers to their clients. What's clear to the insider, but probably confusing to institutions beginning in the private equity asset class, is that institutions must understand where their adviser sits depends on where he or she stands, which essentially means knowing where an adviser derives its revenue. There could be a conflict issue when an adviser that makes the bulk of its revenue from fund-of-funds gives advice labelled as independent that involves committing to it's fund-of-funds programme.

Perceived conflicts are by no means insurmountable. Altius Associates began life in 1997 as an idea that emerged from the placement agent Helix Associates. Helix had been invited to do some advisory work that it felt it was in a position to do but was conflicted from doing, given its placement business. From day one, although Altius began with intellectual capital provided by Helix Associates, the functions and boards of Altius were and remain independent. Hess confronts the issue head-on with clients, who retain the right to veto advice, which limits the discomfort factor should Altius recommend a fund for investment that Helix is placing.