

Use of Private Market Investments in Portfolios: *Opportunities and Risks*

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Austin, TX



Private Market Investments

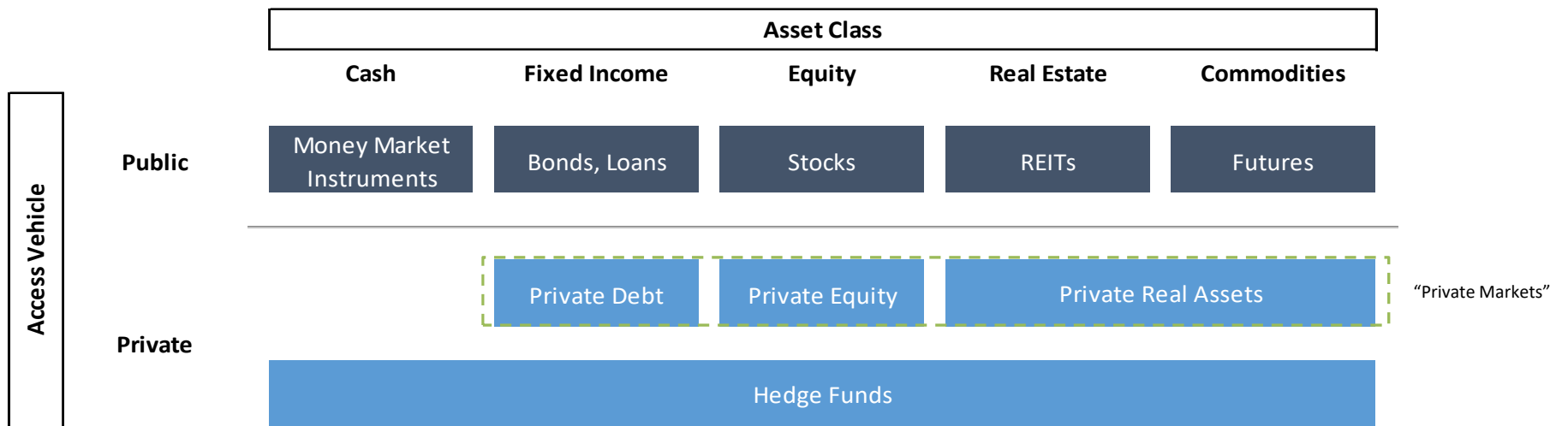
Agenda

- Overview
- Market Environment
- Key Benefits and Considerations
- Portfolio Construction
- Opportunities and Risks



Overview

Definitions



Source: Gallagher Fiduciary Advisors | For illustrative purposes only



Overview

Different Types of Private Market Investments

- **Private equity:** Invests in private companies or “buy out” public companies where managers have active role in value creation
- **Private debt:** Invests in some form of credit instruments through either direct origination or trade in secondary markets
 - Examples: senior debt, mezzanine debt, distressed debt
- **Private real assets:** Invests in physical assets with direct claims to returns generated by those assets



Overview

Common Characteristics

- Access via limited partnership structures
- Relative illiquidity either at the fund level and/or in regard to underlying assets
- Risk/return characteristics that differ from traditional long-only equity and fixed income investments
- May use fund or investment level leverage
- Underlying investments may include esoteric and non-traded assets that are difficult to value and highly subjective



Market Environment

Current Private Market Environment

Fundraising Environment

- LPs continue to commit significant capital to private market funds to generate higher returns
- GPs are coming back to market earlier than usual to raise subsequent funds (despite slight slowdown in fundraising in 2018)
- Notable bifurcation in fundraising market:
 - Larger private market funds are dominating fundraise market
 - Top performing funds are heavily oversubscribed

Deal Environment

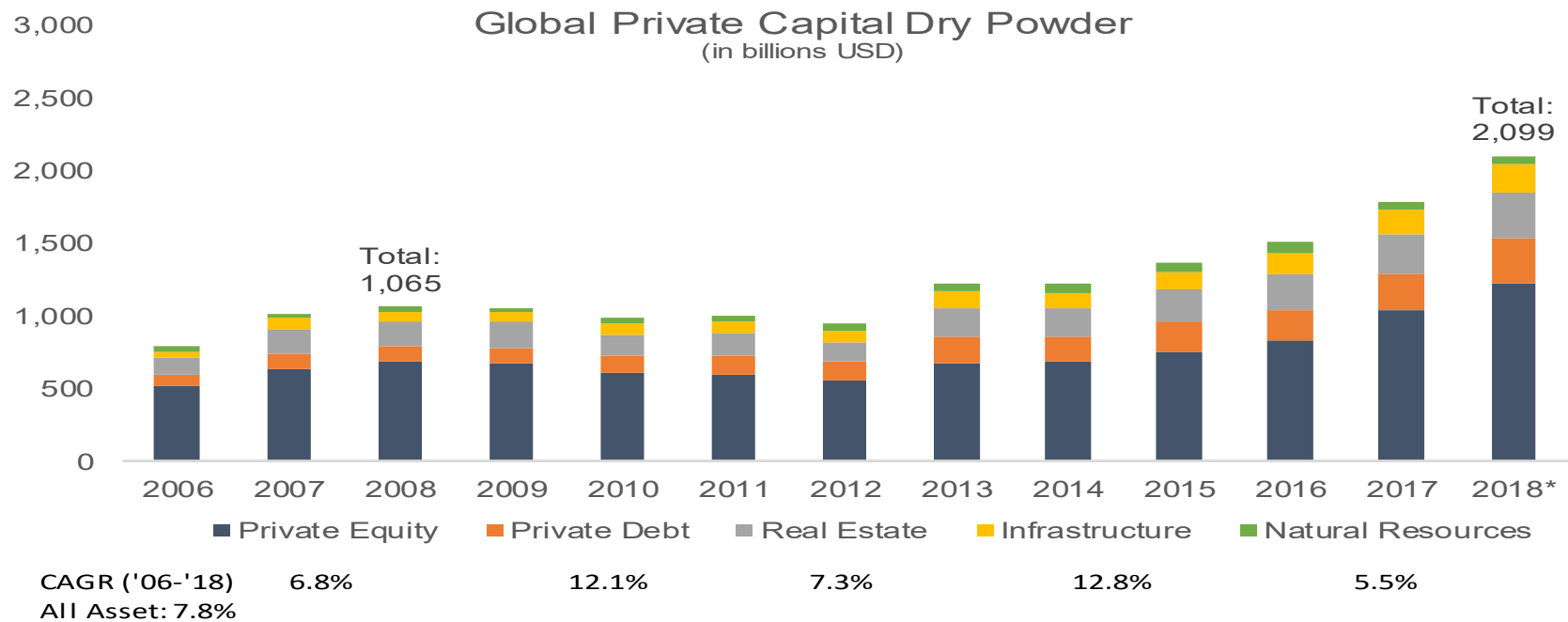
- Deal pricing/ valuation remain elevated, fueled by:
 - Cheap credit
 - Significant level of dry powder
- Leverage multiples are at an all-time high but managers are more prudent in terms of:
 - Equity contribution percentage
 - Coverage ratios



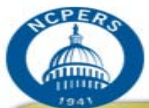
Market Environment

Private Market Dry Powder

Capital overhang is near all-time high...



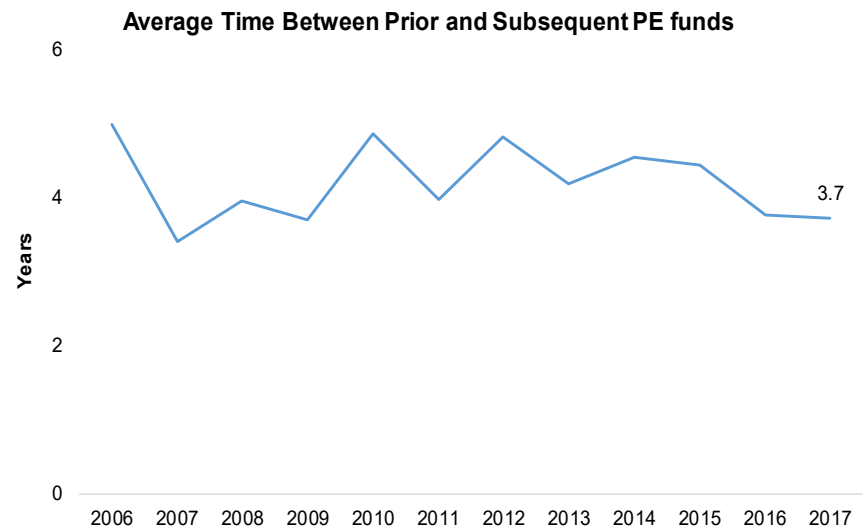
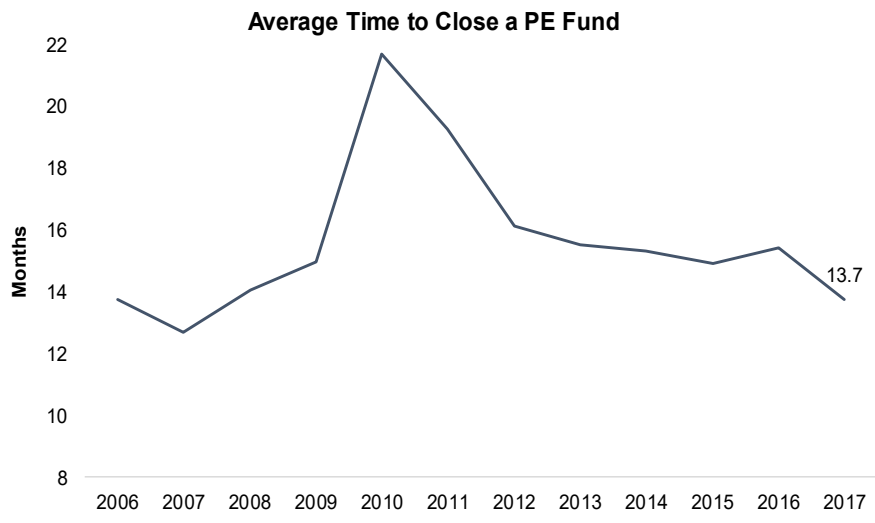
*As of June 2018 | Source: Preqin, Gallagher Fiduciary Advisors



Market Environment

Private Market Dry Powder

GPs are raising capital quickly...



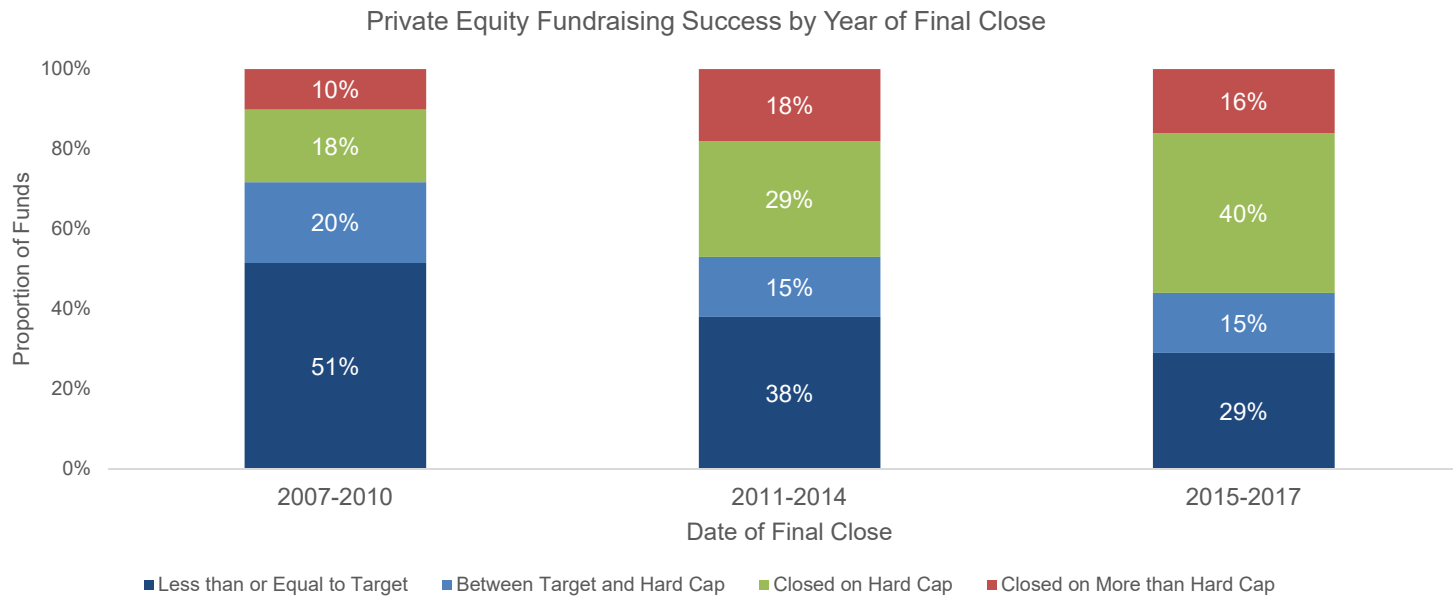
Source: Pitchbook | As of Q1 2018



Market Environment

Private Market Dry Powder

... And Successfully



Source: Preqin

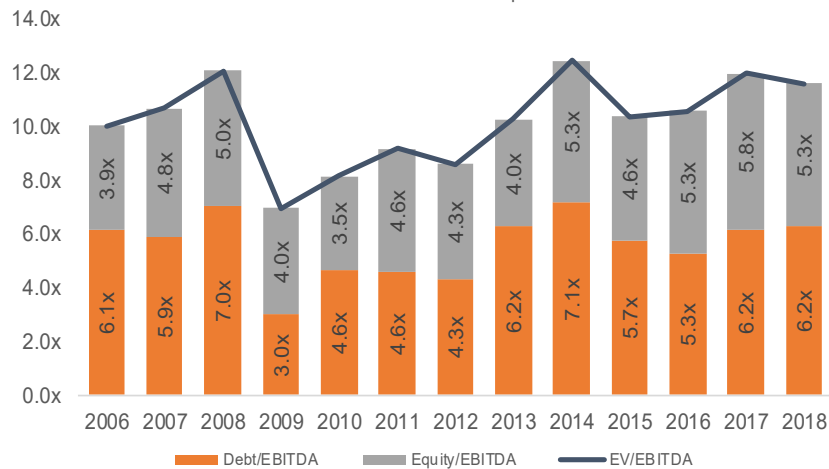


Market Environment

Deal Valuation

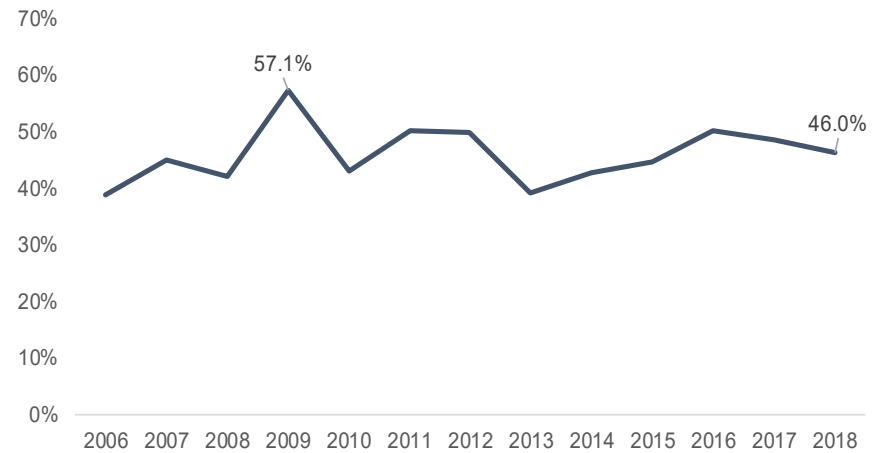
Multiples are also near all-time highs with heavy debt loads

US PE Buyout Multiples
Median EV/EBITDA Multiples



Source: "US PE Breakdown." Pitchbook | As of December 2018

US PE Buyout - Median Equity Contribution %



Source: "US PE Breakdown." Pitchbook | As of December 2018

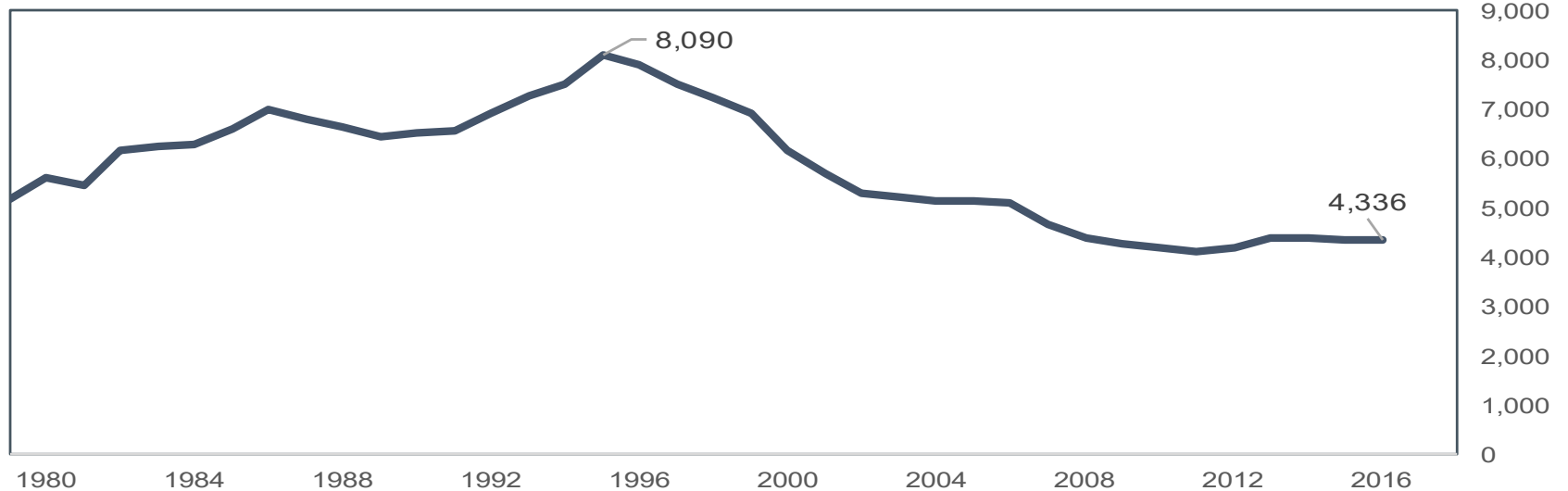


Private Market Investments

Public market under-represents US equity market

The number of publicly traded companies is declining...

Listed Number of Companies - United States
(1980 - 2017)



Source: World Bank; Gallagher Fiduciary Advisors

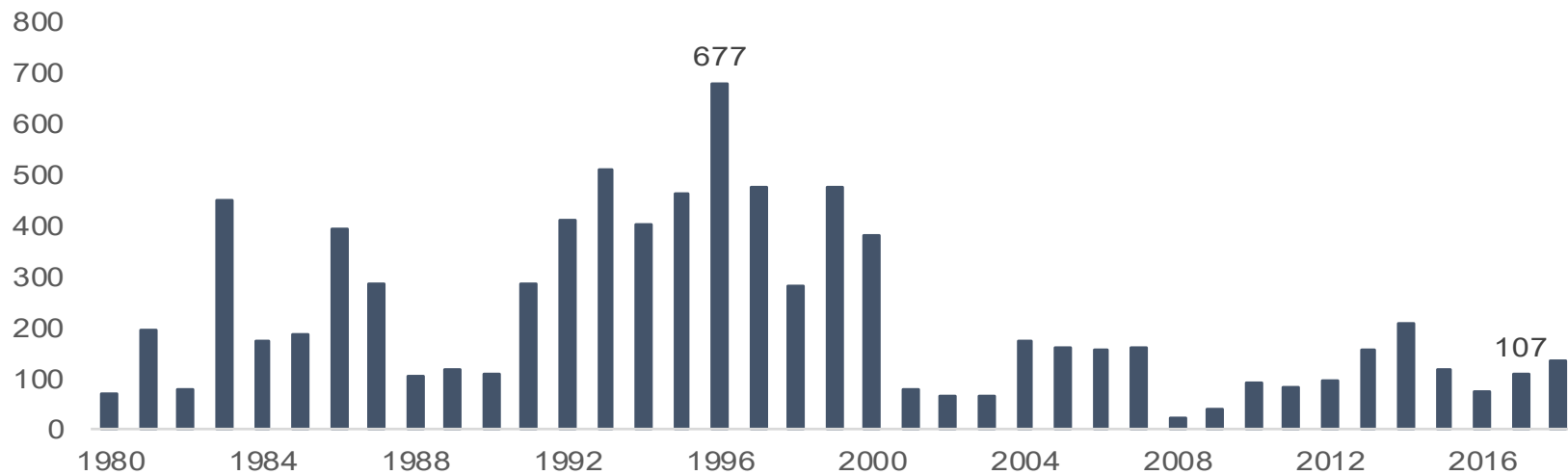


Private Market Investments

Public market under-represents US equity market

... And new companies are not coming to the public market

**Number of IPOs in the U.S.
(1980 - 2018)**



Source: Jay R. Ritter, University of Florida; Gallagher Fiduciary Advisors



Private Market Investments

Key Benefits in a Portfolio

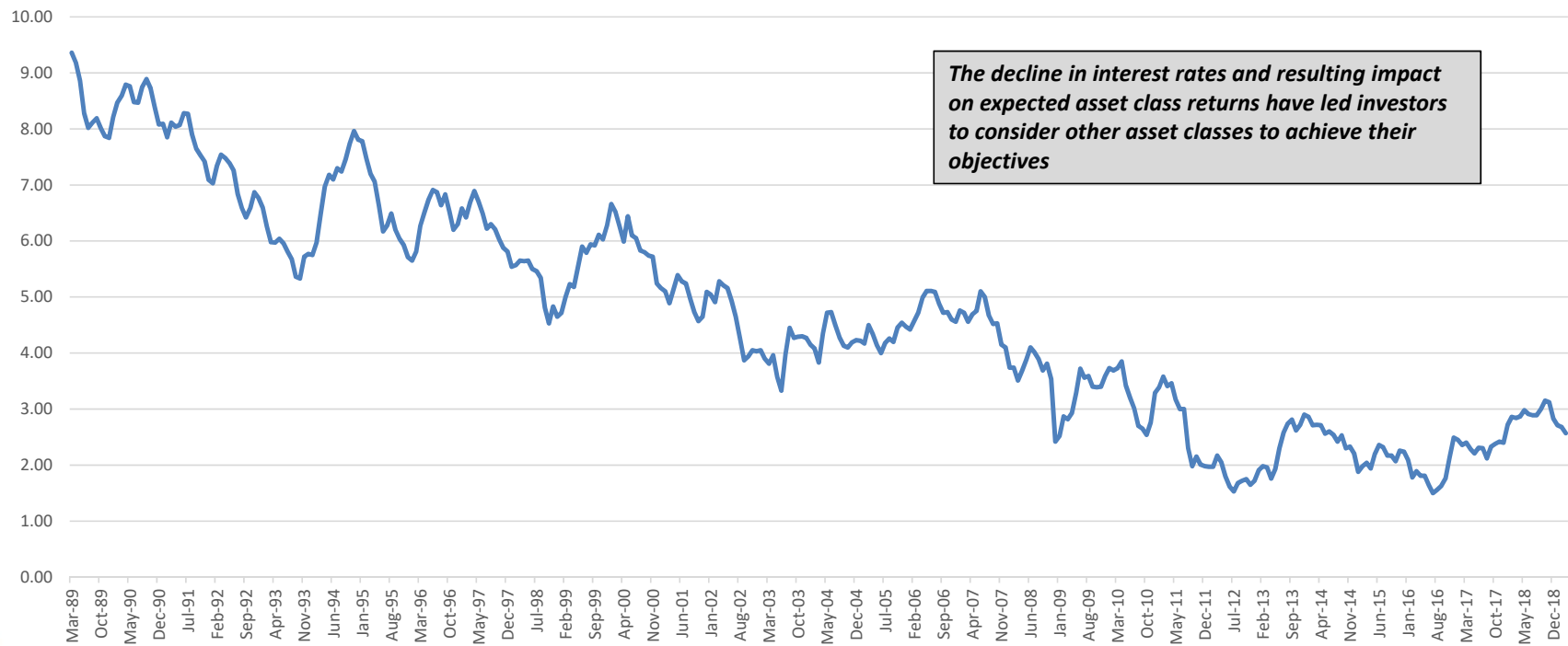
- **Enhanced returns.** Over long-term, private markets may achieve 200 – 500 bps additional return over public market counterparts through active ownership
 - Private market investors take more active role in sourcing, adding value and exiting investments
 - May access assets that are under-represented by public markets
- **Diversification.** Valuation of underlying investments may be driven by factors different from those of public markets
 - e.g. Insurance-Linked Securities may have return/risk profile that is completely different from general market cycle
 - “Core” real assets also less impacted by market shifts



Private Market Investments

Decline in Interest Rates

Historical 10 Year Treasury Yield (March 1989 to March 2019)



The decline in interest rates and resulting impact on expected asset class returns have led investors to consider other asset classes to achieve their objectives

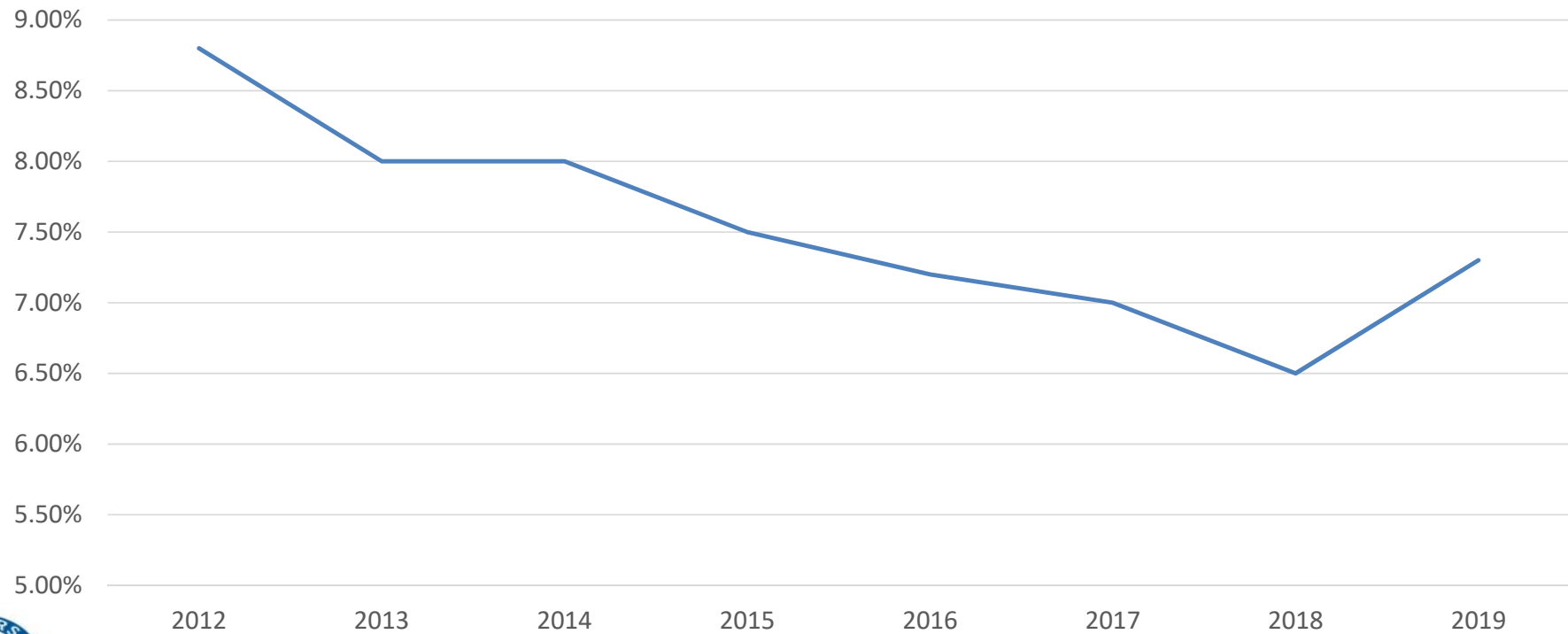
Source: FactSet



Private Market Investments

Decline in Expected Returns for Global Equity

Global Equity Expected Return Assumption (2012 - 2019)

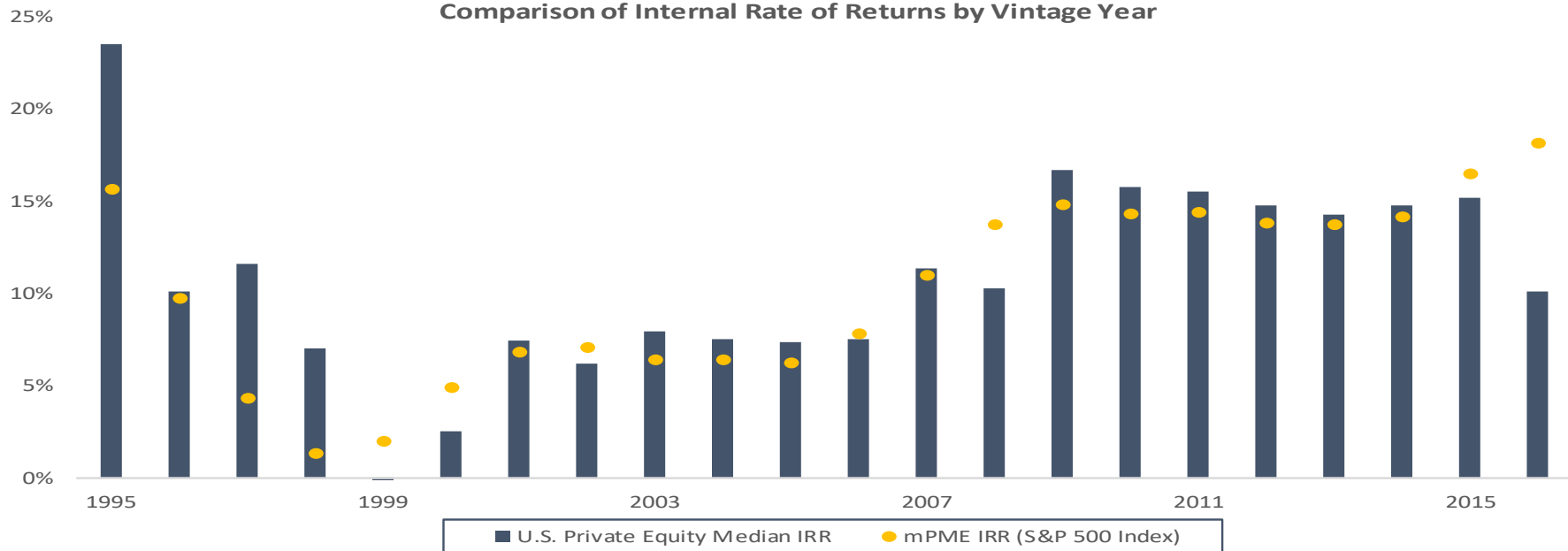


Source: Gallagher Fiduciary Advisors

Private Market Investments

Public market vs private market performance

U.S. Equity Market Performance - Public vs Private
Comparison of Internal Rate of Returns by Vintage Year

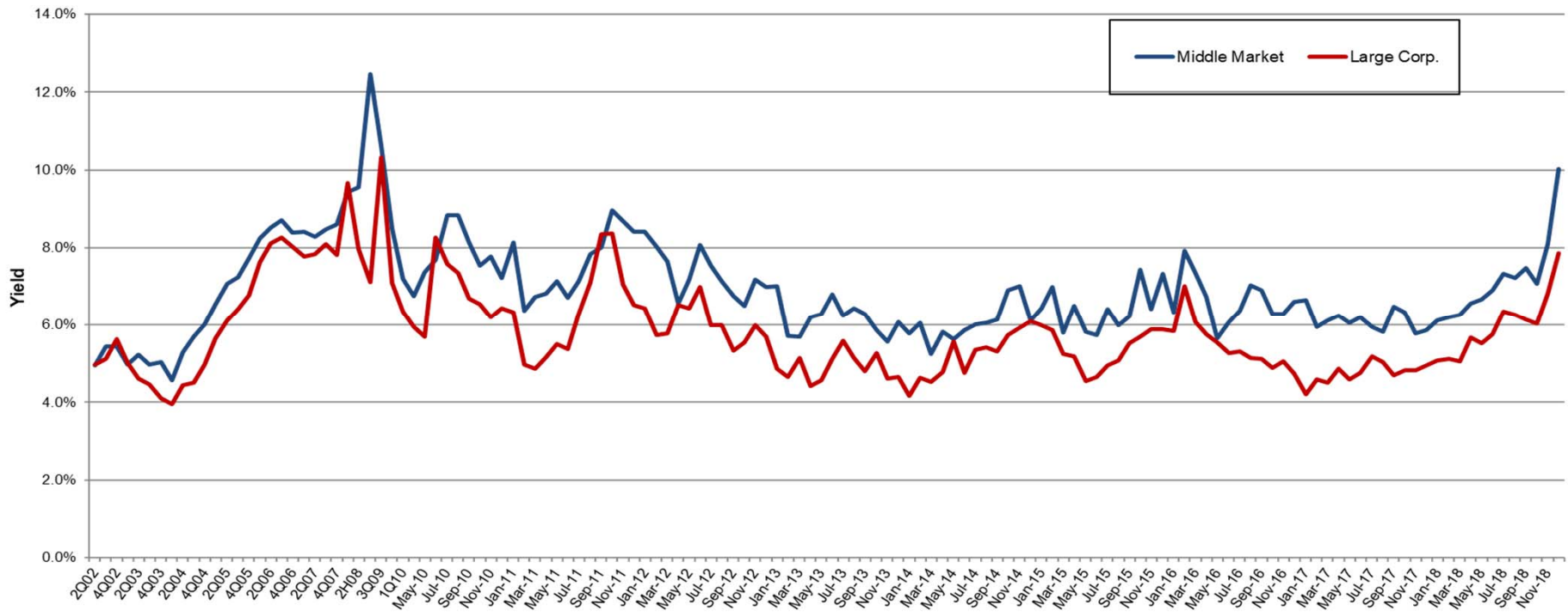


Cambridge Associates Modified Public Market Equivalent (mPME) calculates how the private funds would have performed if invested in S&P 500 instead with the identical cash flow profile. If mPME is higher than the PE Median IRR, it indicates that public market equity would have outperformed the PE counterpart for the vintage year.
Source: Cambridge Associates, Refinitiv, Standard & Poor, Gallagher Fiduciary Advisors | Data as of Q3 2018



Private Market Investments

Private Debt - Yield Comparison

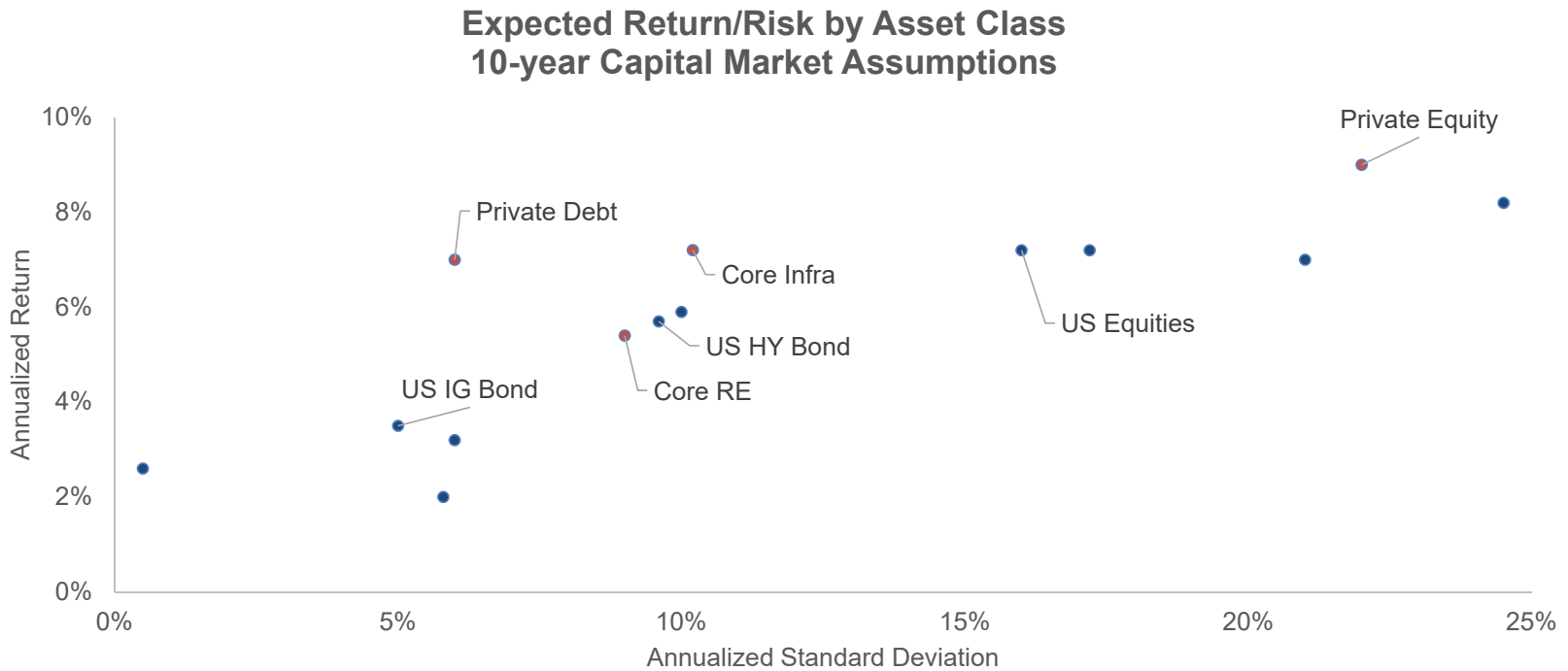


Source: Thomson Reuters. Data through December 2018.



Private Market Investments

Asset Class Return/ Risk Profile



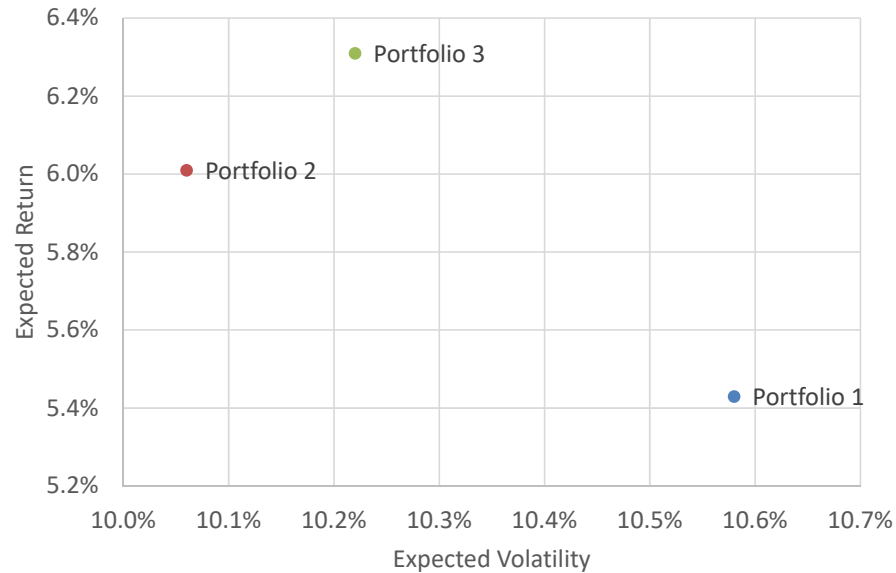
Based on 10-year return and standard deviation projections developed by Gallagher Fiduciary Advisors for 2019.
Source: Gallagher Fiduciary Advisors



Private Market Investments

Expected Impact of Private Market Allocation

Expected Return and Risk



	Portfolio 1	Portfolio 2	Portfolio 3
Global Equity	60%	50%	45%
Global Bonds	40%	30%	25%
Real Estate (private)	---	5%	10%
Private Debt	---	5%	5%
Infrastructure	---	5%	5%
Private Equity	---	5%	10%
Expected Return (Geometric)	5.4%	6.0%	6.3%
Expected Volatility	10.6%	10.1%	10.2%
Return/Risk	0.51	0.60	0.62

For illustrative purposes only. Based on Gallagher's 10 year Capital Market Assumptions. Actual results may vary.



Private Market Investments

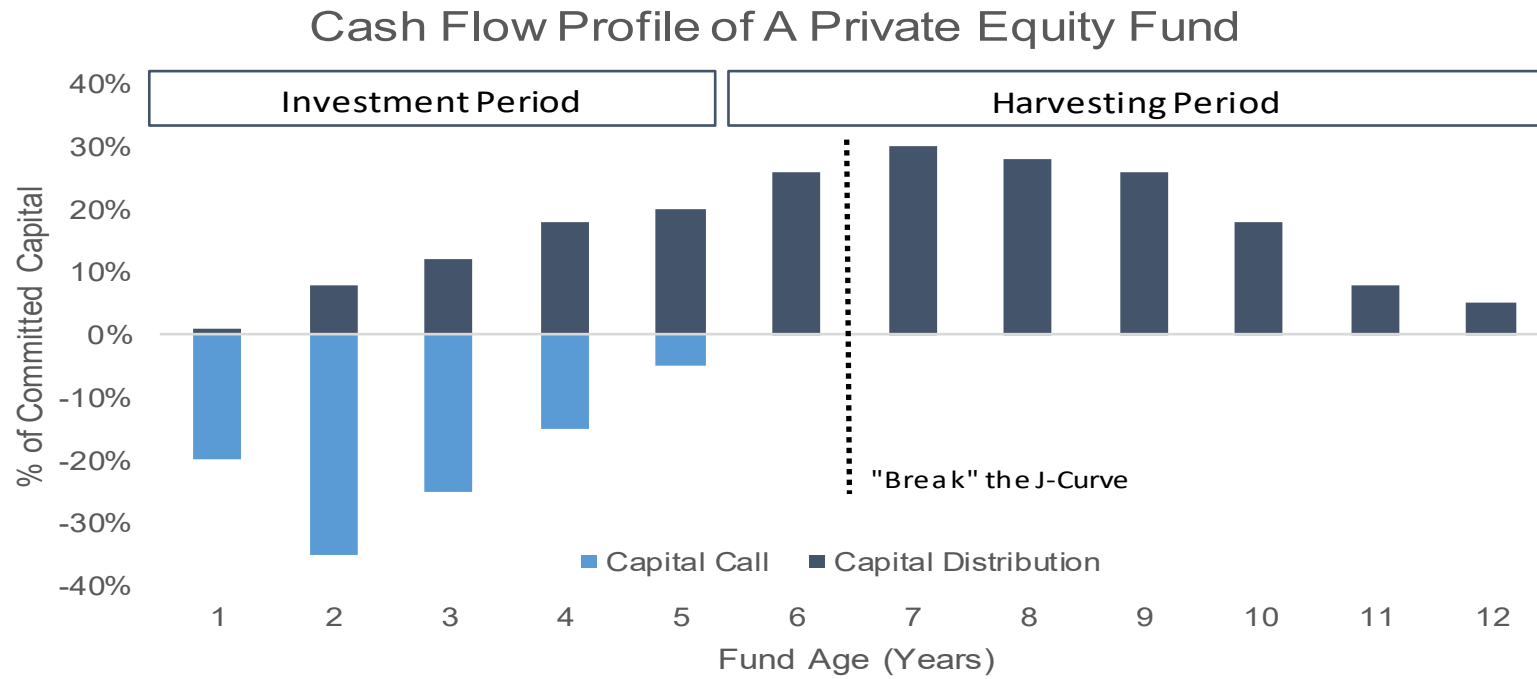
Key Considerations - Illiquidity

- Closed-end private market funds generally have a 8 - 12 year fund life
- Limited Partners (LPs) are legally committed to making contributions whenever capital is called by manager
- LPs usually have no control over capital in/outflow and timing of cash flow can be unpredictable
- LPs usually cannot exit a fund unless:
 - Fund reaches its end of life and winds down
 - No-fault/ At-fault “Divorce” clause is activated
 - LP stakes are sold in secondary transactions



Private Market Investments

Key Considerations – J-Curve



Source: Gallagher Fiduciary Advisors; For illustrative purposes only



Private Market Investments

Key Considerations – High Fees

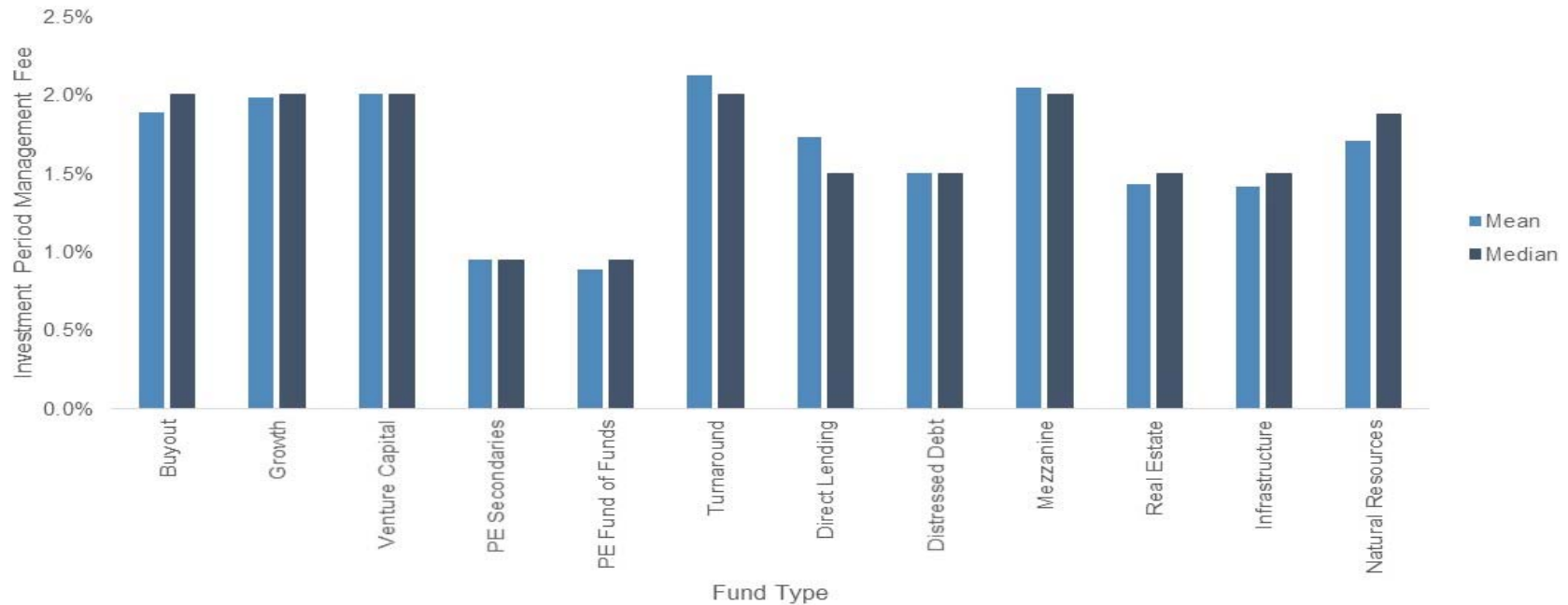
- Unlike hedge fund industry, some private market funds still command “2 and 20” fee structure
- Management fee may be paid on committed capital (typical for private equity) or invested capital (private debt)
- Carried Interest if it reaches certain minimum return (“preferred return”)
- There is a high degree of variability in fees across funds, but in general private funds still receive substantially larger fees than public market funds



Private Market Investments

Fees by Private Market Funds

Management Fee during Investment Period by Fund Type



Note: Includes funds currently raising and vintage 2016/2017 funds; Chart shows management fees during investment period (management fee charged post-investment period may be different)

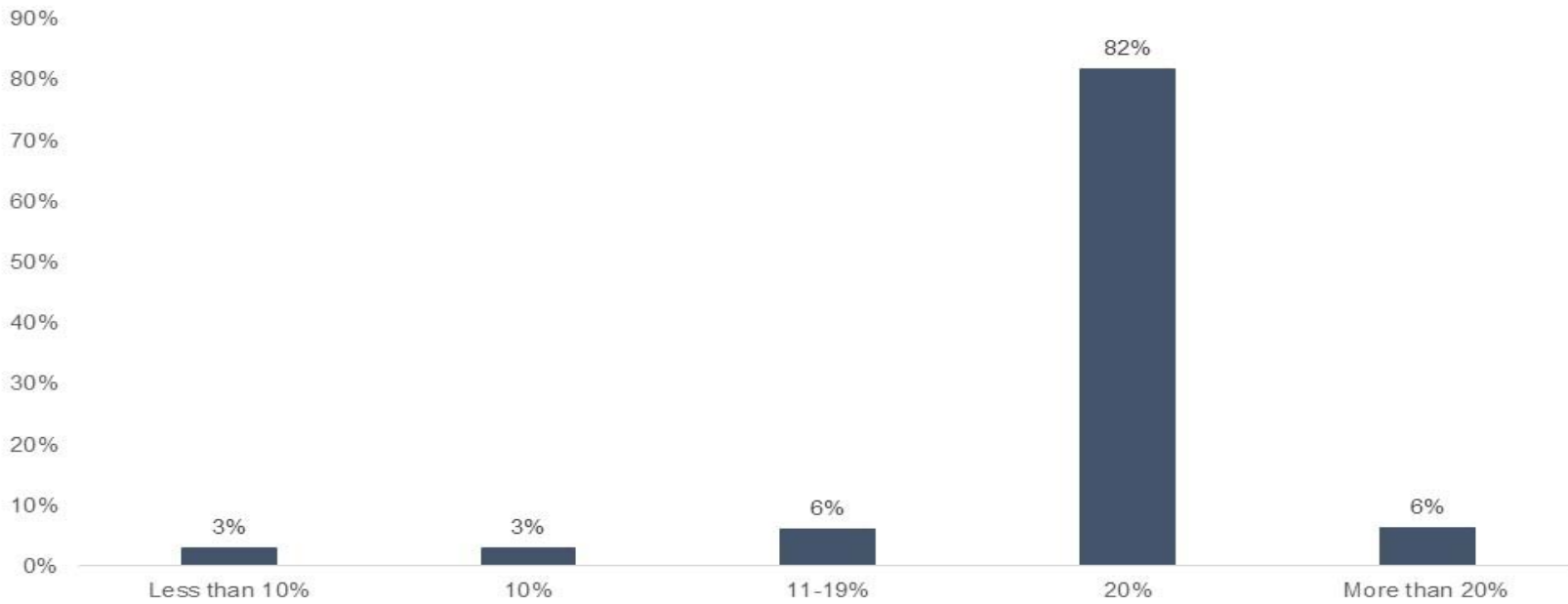
Source: Preqin Private Capital Fund Terms, October 2017



Private Market Investments

Fees by Private Market Funds

Carried Interest Rate Used by Direct Private Capital Funds
Portion of Funds in the Market



Note: Includes funds currently raising and vintage 2016/2017 funds

Source: Preqin Private Capital Fund Terms, October 2017



Private Market Investments

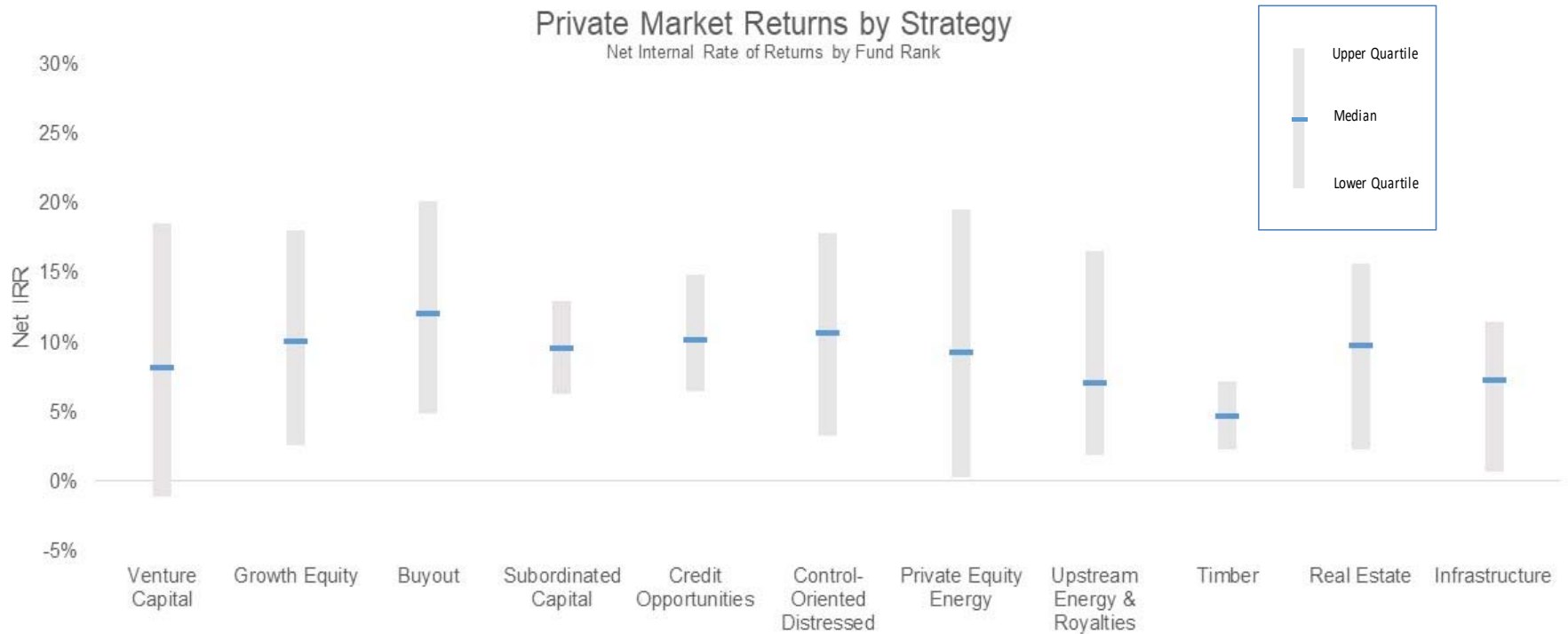
Key Considerations – Performance Variation

- Private market funds apply the most active form of investing, where investment managers:
 - Source and negotiate deals through private channels
 - Get actively involved in assets' operational and financial strategies
 - Look to invest and exit relatively quickly (5-7 years) due to finite fund life
- As a result, fund performance is highly dependent on managers' capability and professional sourcing network, which vary widely
- But prior fund performance has some tendency to persist to subsequent funds, ceteris paribus



Private Market Investments

Performance Variation – Return Gap by Strategy



Source: Cambridge Associates, Refinitiv, Gallagher Fiduciary Advisors | Return data include all periods available to the strategy with first vintage starting in 1981 (venture capital) to 1994 (infrastructure)



Portfolio Construction

Accessing and Managing Private Markets Portfolio

- Investors can manage private market portfolios either internally or externally
 - In-house private market team vs external fund-of-fund manager
 - Each have advantages and disadvantages
 - Typically investors with large allocation to private markets will manage portfolio internally
- Investors' internal vs external decision also varies by asset class and strategy
 - Investors may directly select managers in lower risk strategies (e.g. core/core plus real estate funds, direct lending) but rely on a fund-of-funds allocation for others
 - Investors may have practical and legal difficulties investing in a particular asset class/ strategy (e.g. venture capital funds), necessitating reliance on external help



Portfolio Construction

Accessing and Managing Private Markets Portfolio

	Internal	External
Description	Invest and manage a private markets program through an internal team	Invest in commingled fund or separate account managed by fund of funds managers
Advantages	<ul style="list-style-type: none"> • Ability to build an effective and diversified portfolio tailored to portfolio needs (assuming sufficient scale) 	<ul style="list-style-type: none"> • Relatively simple, one-stop solution to private markets • Broader diversification • Better access to managers • Potential information advantage through economies of scale and scope
Disadvantages	<ul style="list-style-type: none"> • May require significant resources to build a capable team • Potentially higher investment risk 	<ul style="list-style-type: none"> • Less control over allocation strategy • Dual layer of fees • Typically lower return

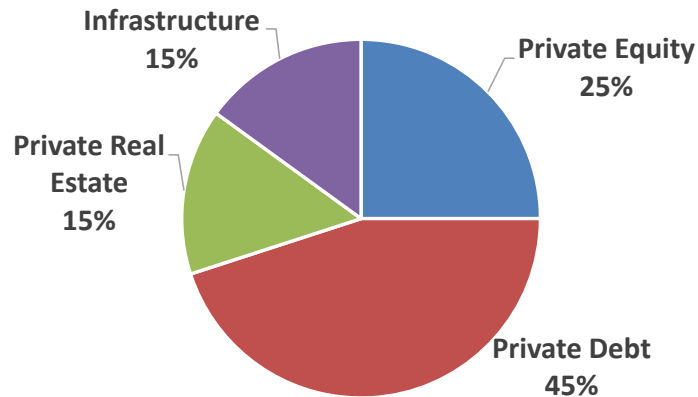


Portfolio Construction

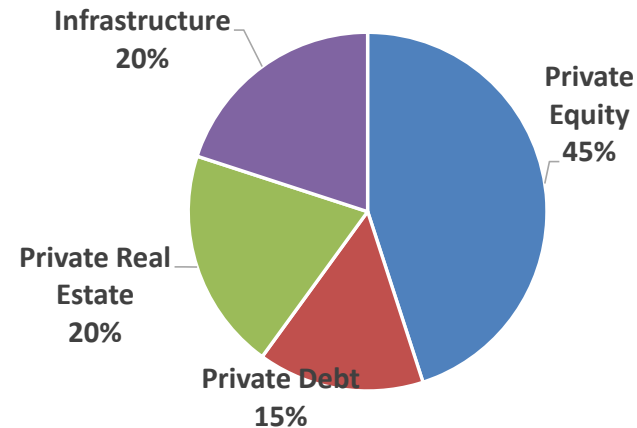
Private Market – Total Portfolio

- Depending on investors' liquidity needs, risk tolerance and return objectives, they can construct a private markets portfolio across various asset classes and strategies:

"Sample Portfolio 1"



"Sample Portfolio 2"



For illustrative purposes only.

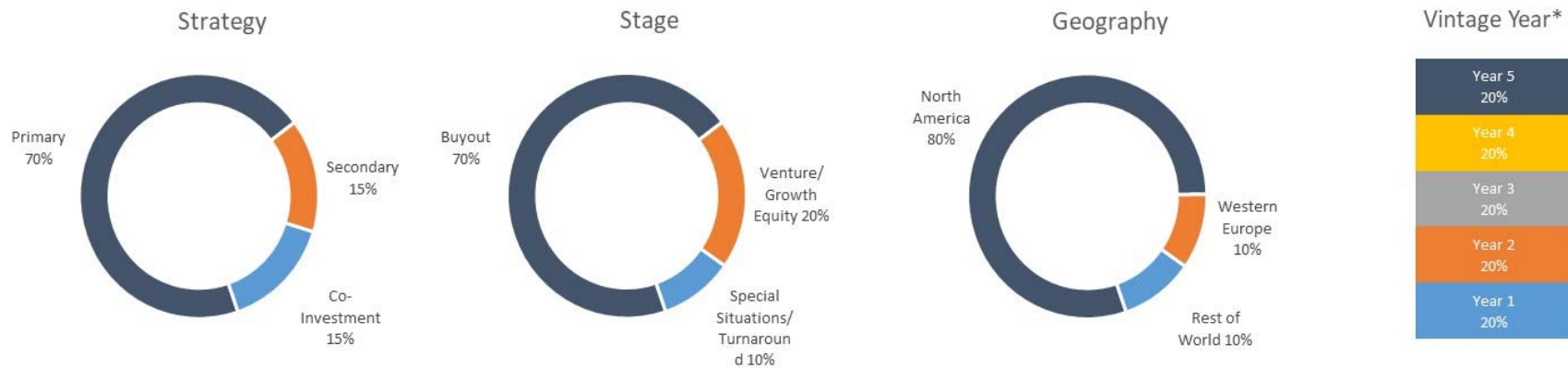


Portfolio Construction

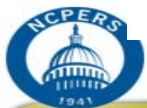
Principles & Objectives – Private Equity Example

- An ideal private market portfolio:
 - A blend of primaries, secondaries and co-investments
 - Diversified by stage, sector, geography, size and time (vintage year)
 - Mitigating J-Curve (as much as possible)

Sample Portfolio Target Allocation

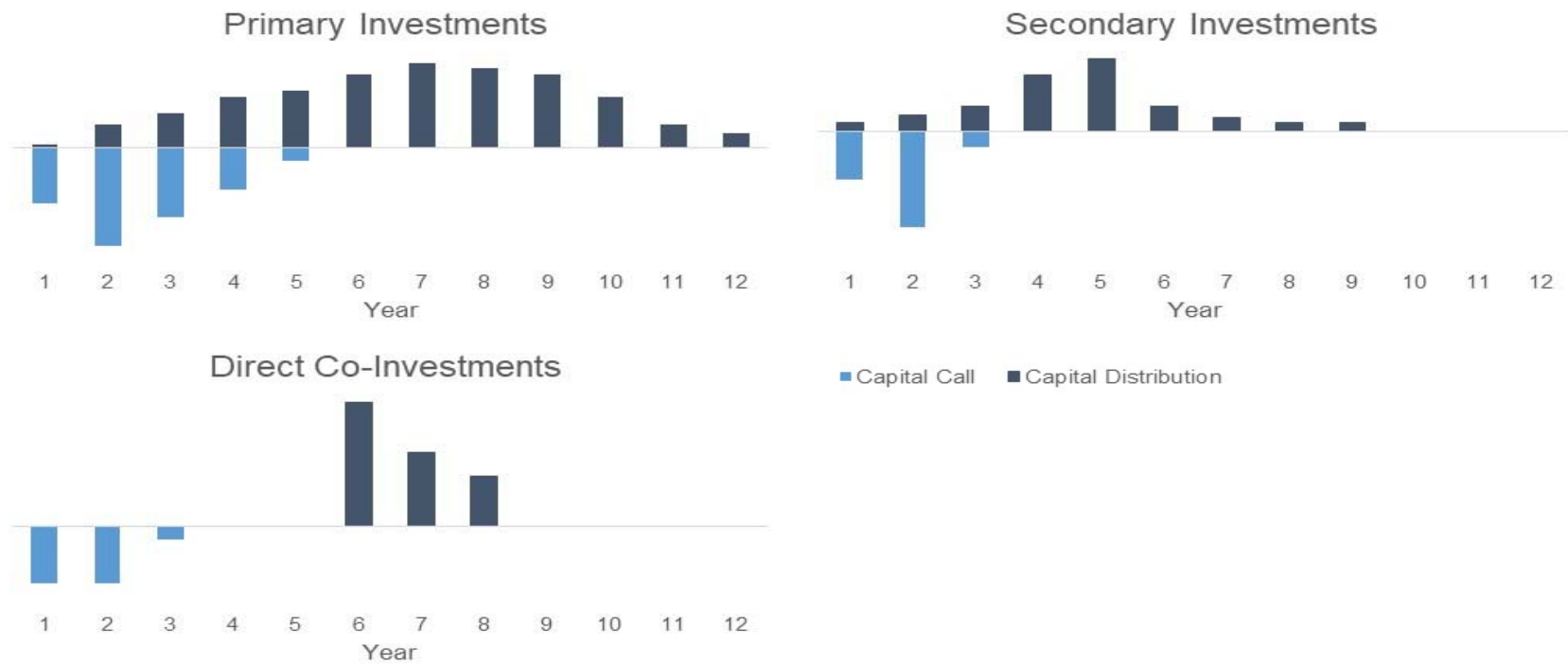


Source: Gallagher Fiduciary Advisors | For illustrative purposes only
 * Funds in investment period only



Portfolio Construction

Illustrative Cash Flow Profiles



For illustrative purposes only
Source: Gallagher Fiduciary Advisors



Opportunities and Risks

Private Market as an Asset Class

Private market investment is a difficult but a rewarding asset class

Negatives

- **Complexity.** Highly complex and opaque asset class
- **No Benchmark.** No good performance “bogey” makes it difficult to assess performance
- **Expensive.** Both management fees and carried interest are high
- **Illiquidity.** Usually locked in without control over capital flow for ~10 years
- **High Performance Variance.** Among managers, vintage years and strategies

→ Private market funds are difficult to analyze and the cost of getting it wrong is high...

Positives

- **(Some) Return Persistence.** Successful manager in the past tend to be successful in the future (although with caveats)
- **Enhanced Return.** Asset class tend to outperform public market counterparts in the long run.
- **Diversification Benefits** - Valuation of underlying investments may be driven by factors different from those of public markets

→ ... But it is possible to select “good” managers and the asset class in general has outperformed the public equivalents.



Opportunities and Risks

Current Private Market Environment

Requires caution but continued allocation to the asset class is critical

Risks

- Private markets are heated:
 - Capital raise and dry powder are at or near all-time highs
 - Valuations, and leverage level, across the board are also elevated
- Manager selection is key:
 - Identify managers that have managed investments through cycles
- Liquidity Analysis:
 - Understand the impacts market downturns may have on portfolio liquidity needs

Opportunities

- Overall AUM level of private markets still a very small portion to public markets
- Although valuations are high, other fundamentals of companies are solid
- Can't time the market for this asset class given long-term nature
- Also pockets of opportunities in sub-asset classes where there are more structural advantages:
 - Smid cap > large/ mega cap
 - Value-orientation > Growth-orientation
 - Non-cyclical market focus with conservative underwriting process



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