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INSTITUTIONAL

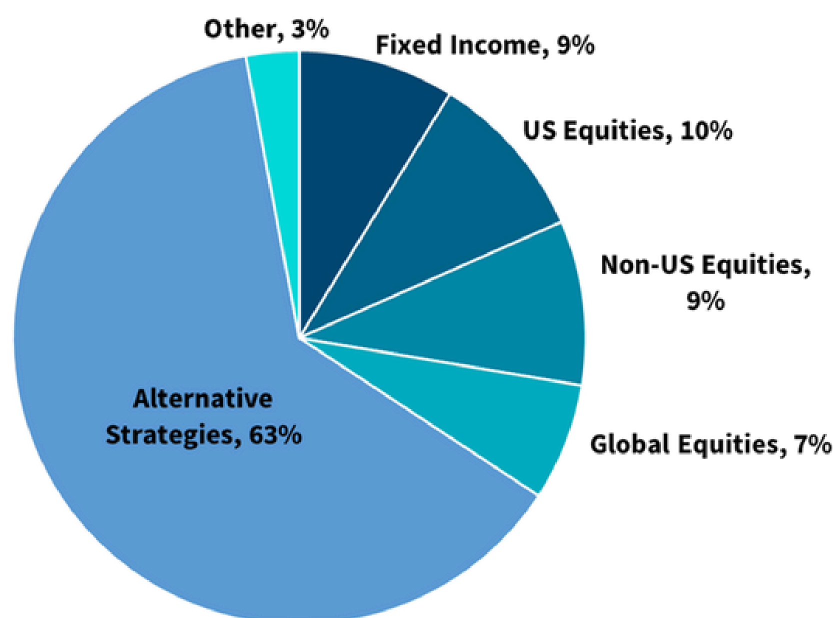
Private Capital

"If you asked the public what they wanted, they would have said a faster horse" -Henry Ford

Private & Alternative Investment Management

Those in endowment management most certainly have heard of legendary investor, David Swenson. He served as the Chief Investment Officer of the Yale University Endowment from 1985 until his passing in 2021. Under Swensen's leadership, the Yale Endowment saw remarkable growth. From the time he took over in 1985 to around 2020, the endowment grew from about $1 billion to over $30 billion. His management yielded an annualized return of approximately 13.1% from 1985 to 2020, significantly outperforming broader market benchmarks.

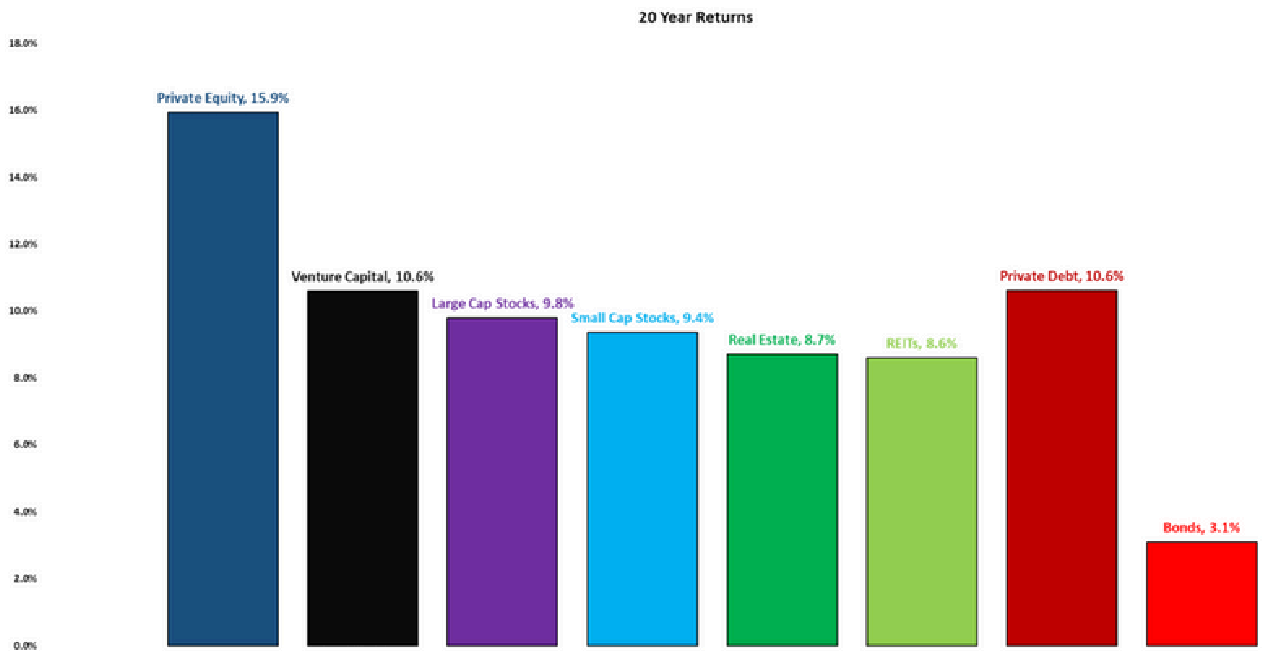
A large part of Swenson's success may be attributed to his willingness to look significantly different than peers, take a very long-term view, and to incorporate a heavy allocation to private and alternative[1] investments. This approach today is often referred to as the "Yale Model" or the "Endowment Model" of portfolio management.[1]



Swenson and Yale helped to formalize the private investment industry, and while they may sound opaque or provocative, private investments are often not too dissimilar from public ones in their base characteristics. For example, an investor who owns a publicly-traded stock or a privately held business both has the right to their proportionate share of company assets and future cash flows. The same is true for an owner of a publicly-traded real estate investment trust and the owner of a portfolio of buildings held privately. Public companies offer more liquidity than private ones, but being publicly-traded also comes with greater exposure to market volatility and price swings. Public companies have better transparency as they are subject to specific and standardized reporting requirements. Owners of private companies often have greater ability to drive value and operational improvements than passive owners of publicly-traded stock. And, the opportunity set for private investors is significantly greater, often with better pricing and lower competition;

1 Casavecchia, L. (2008). David F. Sewnsen and the Yale Model of Endowment Management. Journal of Portfolio Management, 34(3), 23-28
2 2023 NACUBO-TIAA Study of Endowments.
All data are dollar-weighted. Alternative strategies include: marketable alternatives (hedge funds), private equity, private venture capital and real assets. Private debt included in Fixed Income

there are approximately 665,000 private companies in the US and only 6,000 publicly-traded ones.[3] Likely due to these attributes, private investments are expected to provide portfolios with enhanced long-term returns relative to public markets. And, larger institutions with potentially greater sophistication and larger allocations to alternative and private investments have historically outperformed their smaller peers.[4]



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3 Private companies are those with more than 20 employees according to the US Census Bureau published March 2023. Public companies represented by total listings on the New York Stock Exchange and the NASDAQ as of February 2023
4 Source: 2023 NACUBO-TIAA Study of Endowments.
All data are dollar-weighted. Alternative strategies include: marketable alternatives (hedge funds), private equity, private venture capital and real assets. Private debt included in Fixed Income.
5 Source: Pitchbook for private capital indices, Morningstar for public market indices. Date as of December 31, 2022 Data based on Pitchbook private capital manager categories and quarterly returns. Private Equity comprised of Buyout, Growth, Restructuring, and Diversified categories. Real Estate comprised of Value-Add, Opportunistic, Core, Core-Plus, and Distressed Private Debt comprised of Direct Lending, Distressed Debt, Mezzanine Financing, Bridge Financing, Special Situations, Infrastructure Debt, Real Estate Debt, and Venture Debt

Summary Asset Allocations for U.S. College and University Endowments and Affiliated Foundations, Fiscal Year 2022*

Size of Endowment	U.S. Equities %	U.S. and Non-U.S. Fixed Income %	Non-U.S. Equities^ %	Global Equities %	Alternative Strategies* %	Other %
Over $1 Billion	8.80	9.54	9.26	6.80	62.61	2.99
$501 Million to $1 Billion	21.43	14.94	13.96	5.73	42.87	1.07
$251 Million to $500 Million	21.04	15.83	11.26	9.00	40.55	2.32
$101 Million to $250 Million	28.19	19.16	13.27	8.66	30.11	0.61
$51 Million to $100 Million	34.34	23.70	12.65	7.76	20.39	1.16
$25 Million to $50 Million	39.12	26.44	14.04	3.62	16.05	0.73
Under $25 Million	44.71	32.68	13.10	1.34	7.77	0.40

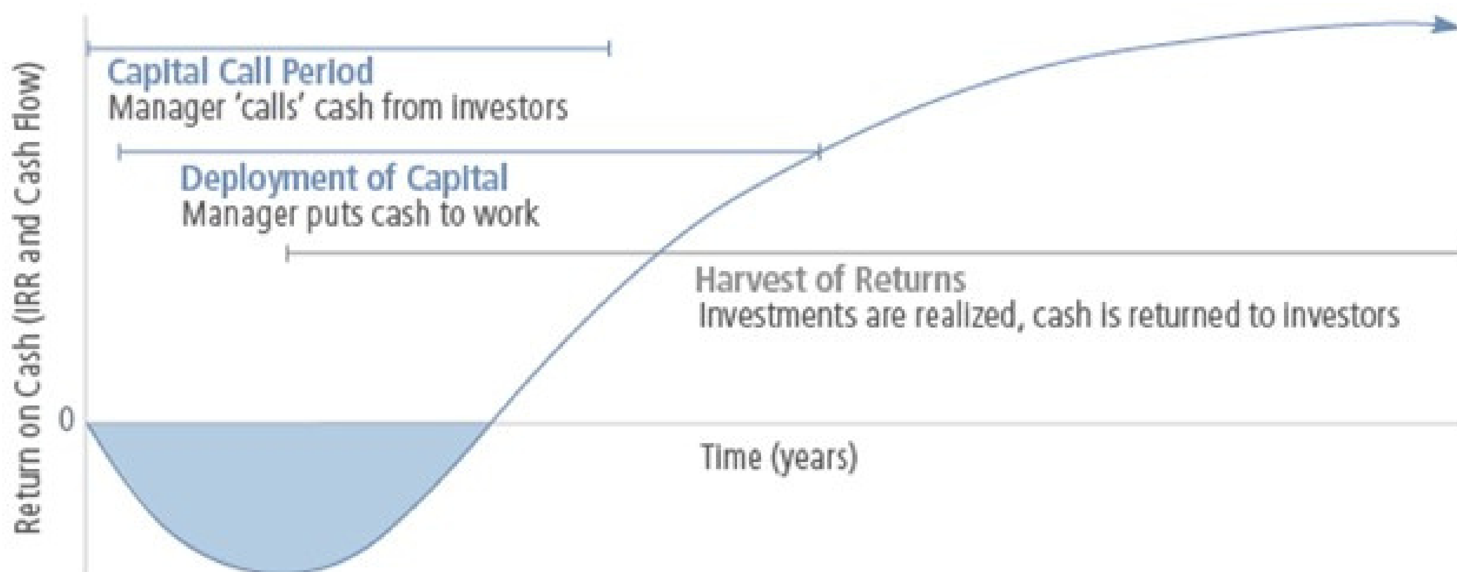
Average Annual One-, Three-, Five-, and Ten-Year Returns* for U.S. Higher Education Endowments and Affiliated Foundations for Periods Ending June 30, 2022

Size of Endowment	1-year % N=678	3-year % N=629	5-year % N=620	10-year % N=554
Over $1 Billion	-4.46	10.49	9.41	8.91
$501 Million to $1 Billion	-5.70	8.52	7.84	7.93
$251 Million to $500 Million	-7.76	7.65	7.24	7.56
$101 Million to $250 Million	-9.02	6.84	6.97	7.83
$51 Million to $100 Million	-9.71	5.75	5.94	6.89
$25 Million to $50 Million	-10.66	5.40	6.20	7.14
Under $25 Million	-11.47	4.40	5.54	7.05

Managing Private Investment Cash Flows

Institutional investment portfolios often have multiple types of cash flows that can present planning challenges for portfolio managers. In addition to regular distributions in support of the organization, the portfolio may receive periodic inflows from gifts or excess working capital as well as extra outflows during periods of market stress (if the organization needs to dip into reserves). Internal to the portfolio, another source of difficult-to-predict cash flows are those that result from commitments to private investments.

Commitments to private investment strategies are made with the expectation that they will provide returns in excess of comparable public market strategies. Of course, seeking out additional return in private markets presents additional complexity and risk, mostly in the form of significant illiquidity. Commitments to private investments and strategies are typically made in fixed dollar amounts by limited partners (the investors), then the general partner (the manager) has discretion to call some or all of the commitment in order to fund and support investments. General partners typically have contractual windows of time during which they are allowed to call capital from limited partner commitments (often 3-5 years from the commitment date), but within these windows the size and timing of cash flows can be highly unpredictable, and are typically based on the pace at which the general partner identifies and consummates underlying investments as well as the overall economic environment (for example, capital calls and distributions often both slow during periods of economic stress as transaction volumes decline). And, since commitments are made in fixed dollars and invested by the underlying general partner sporadically over time, this creates cash flow and risk management challenges for institutional portfolio managers who must account for a litany of other variables such as external portfolio cash flows and the volatility of other portfolio investments such as public equities.

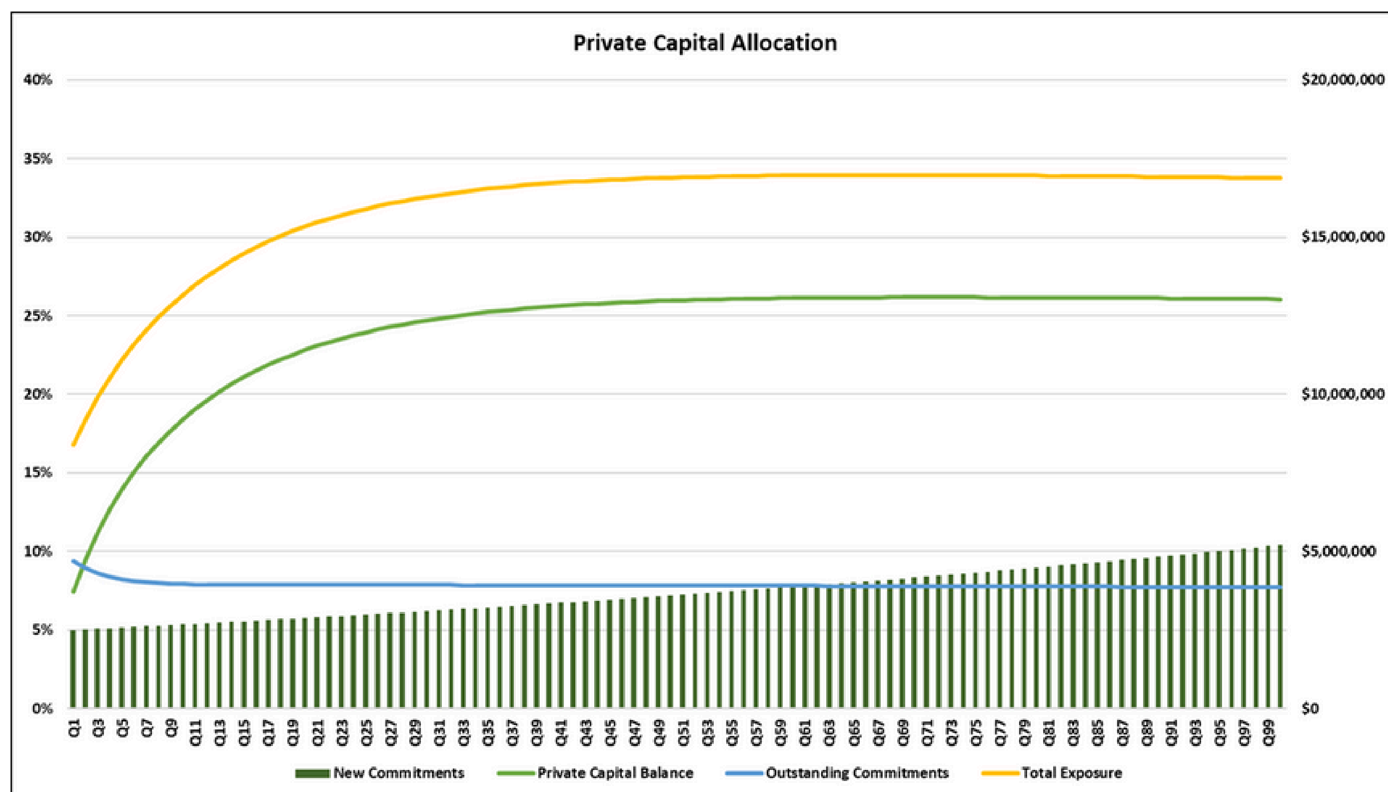


For most institutional portfolios that invest in private strategies, they typically have a large balance to existing investments ("called capital") that is readily reported as an asset on the portfolio's position statement and the organization's balance sheet. However, related to that invested private capital balance is an unfunded commitment made at some point in the past that is frequently not listed as a liability on either the portfolio's position statement nor the organization's financial statements. Unfunded commitments may represent a shadow source of risk that should be better tracked and understood by institutional portfolio managers. This risk was put into the spotlight during the 2008-2009 financial crisis, as several prestigious university endowments, including Harvard University, experienced cash crunch and were forced to sell very illiquid investments at steep discounts.[6] The crisis revealed vulnerabilities in many endowments' strategies, especially those with significant allocations to illiquid assets like private equity, hedge funds, and real assets.

In other words, positive private capital cash flows may dry up or switch to net negative cash flows when the portfolio needs liquidity most. It is incumbent upon institutional portfolio managers and fiduciaries to keenly understand these dynamics and have a plan in place for stressed market conditions.

Building a mature private capital program cannot easily be done overnight.It is recommended that institutional portfolio managers and fiduciaries build their private capital allocation over at least 3-5 years, but it is highly likely that market and economic conditions along the way will cause the path toward building to private capital targets to be anything but smooth.

6 McDonald, D., & Kambourov, D. (2010). The Wall Street Journal. "Harvard Swaps Are Sobering Lesson for Universities."



Given that private capital commitments are typically made in fixed dollar amounts and given that private capital investments typically experience slower and more shallow declines in value during periods of market stress (a concept called "lagged beta"[7]), this can throw the portfolio "off plan" very quickly. The table below highlights how significantly market movements can impact the allocation of a portfolio that includes private capital investments and outstanding commitments.

	Beginning		Return	Ending	
	Value	Weight		Value	Weight
Public Stocks	$60,000,000	60%	-30%	$42,000,000	52%
Public Fixed Income	$20,000,000	20%	5%	$21,000,000	26%
Private Capital Investments	$20,000,000	20%	-10%	$18,000,000	22%
Total Portfolio	**$100,000,000**	**100%**	**-19%**	**$81,000,000**	**100%**
Unfunded Private Capital Commitments	*$15,000,000*	*15%*		*$15,000,000*	*19%*

7 Anson, M. J. P. (2002). *Private Equity Returns and Disclosure Around the World. Journal of International Money and Finance, 21(5), 727-754.*

In this environment, portfolio managers a left with risky choices. For example, they may be forced to slow or halt new private capital commitments if overall private capital exposure becomes too large (often times by mandate in the institution's IPS). This is problematic because the best private capital vintage years may come from those that began during periods of market stress.In other words, the portfolio may not have the liquidity and flexibility to continue on its private capital pacing plan and may subsequently miss the highest returning vintages of funds. The institution may also choose to run for an extended period of time with private capital exposure that is greater than the original target, which may be limit flexibility to rebalance into liquid asset classes such as stocks or to meet obligations external to the portfolio (e.g., funding new capital projects).
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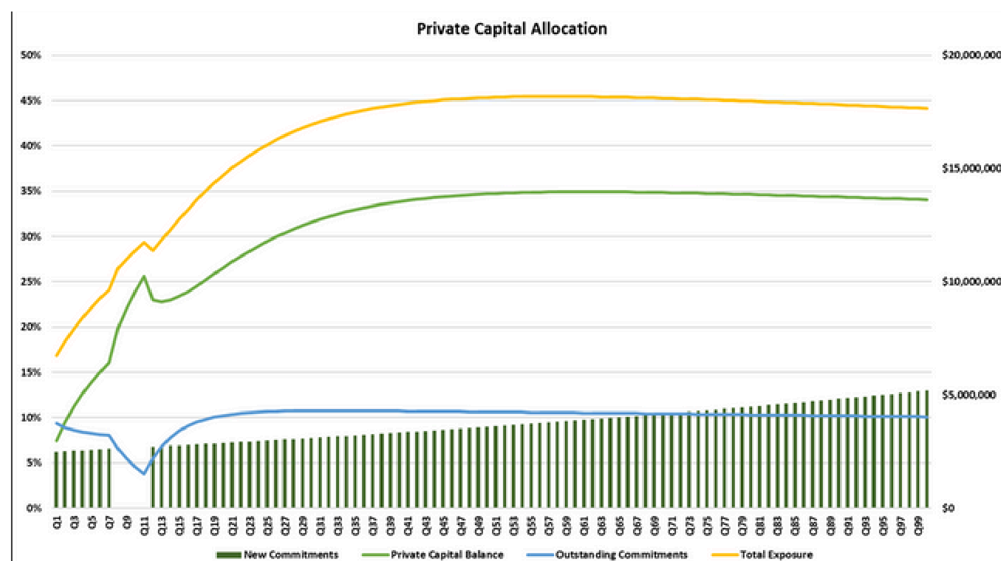
The broader point is that institutional portfolio managers and fiduciaries must balance planning for the unexpected while not being overly conservative in the face of all the potential risks that may befall the portfolio.

Institutions seeking to build a private capital program should plan a long-term glidepath that includes consistent new commitments over at least 3-5 years in addition to establishing other potential methods of optionality during times of market and economic stress such putting in place a line of credit.



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