THE POWER OF A FUND-OF-FUNDS APPROACH IN PRIVATE MARKETS

Russell Investments

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Executive summary:

- Manager selection is critical when allocating to private markets, as there is a large degree of variability in returns between the top and bottom quartile funds, a dynamic that is much more apparent in private versus public market funds. This makes it imperative to identify and access general partners who are accomplished investors with the potential to generate superior returns within their fund.
- An experienced and well-reputed private markets fund investor (limited partner) can access top-tier private equity general partners and their funds. A fund-of-funds approach allows investors to directly benefit from these relationships through access to highly sought-after funds that otherwise would not be accessible.
- While individual client circumstances and objectives may differ, we believe building a foundational exposure to private markets begins with broad diversification across strategy, geography access point and vintage year. We think it is prudent for investors—particularly those who are in the early years of their programs—to obtain meaningful exposure to secondaries and co-investments.

Introduction

Interest and participation across institutional, wholesale and intermediary investors, and private wealth investors in private markets, continue to grow. Indeed, investors continue to increase exposure across the spectrum of private assets including equity, credit, real estate, infrastructure, and impact at the expense of their public market equity and fixed income allocations. Reasons why investors look to structurally increase their private markets exposure include consistent outperformance of private investments over their public market counterparts, as well as access to the significantly larger investable opportunity set that exists in the private sector relative to what is available in the public sphere.

And while most investors would agree that the private markets investment proposition is compelling and demands more of a place as part of their strategic asset allocation mix, there perhaps is less agreement on *what* represents the optimal approach to implementing a private markets investment program. The purpose of this paper is threefold:

1) Understand the additional complexity that is associated with building a high-performing private assets portfolio.
2) Focus on the *how* to invest in private markets by considering key practical aspects of manager selection and portfolio construction.
3) Outline *why* investors should consider a fund-of-funds (FoF) approach, and how this approach to implementation can help unlock the benefits of private investments while addressing the potential risks to create a powerful addition to your total portfolio.

With over 50 years of experience in helping investors successfully integrate private markets into their investment programs, we understand the complexity, potential pitfalls, and risks and how an institutional FoF approach can be the guiding hand required to successfully implement private markets.

Private assets: managing complexity

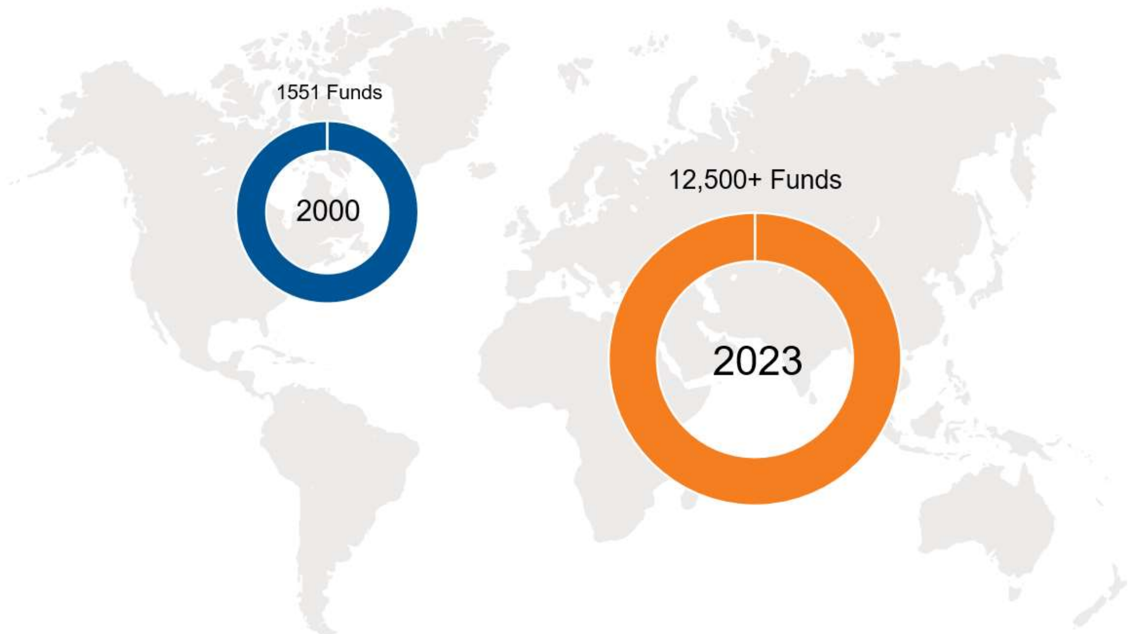
Notwithstanding the increasingly attractive investment proposition that is inherent in private markets, investors need to recognise that relative to traditional stock and bond investments, there is additional complexity that needs to be recognised and given proper consideration. So, let's look at some of these key implemented factors for private assets.

Investment activities

Today, private assets under management globally total $11.7 trillion. [1] Commensurate with the industry's growth over the last 20+ years there has also been an exponential increase in the number of funds raised by private markets firms. According to data from Hamilton Lane[2], there has been a staggering increase of more than 700% in the number of funds raised over the last 20+ years.

Exhibit 1 highlights the growth in the number of funds raised has risen from 1,551 to over 12,500 funds today. [3]

Exhibit 1: Growth in the number of funds raised



The implication of such a substantial increase in the number of funds being raised is that investors need the requisite scale, expertise, and global resources to be able to effectively identify, evaluate and select top-tier investment opportunities across the global private markets landscape.

Also, **manager selection** is crucial to performance. Unlike traditional equity and fixed income managers where the dispersion of returns is less widespread, performance can vary dramatically among private asset managers. As illustrated in Exhibit 2, there is a large degree of variability in the returns between the top and bottom quartile funds. Indeed, the spread in annual internal rate of return (IRR) has been as much as 25.24%. This makes selecting the right managers paramount because even with perfect market views and a thoughtfully constructed portfolio, the negative alpha from poor manager selection can have a sharply

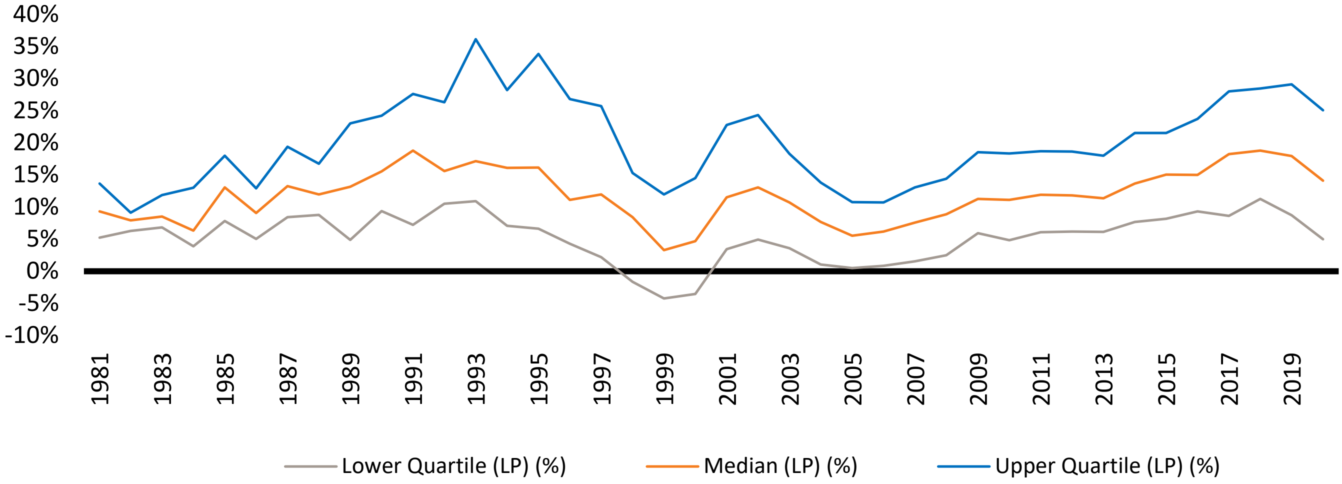
[1] McKinsey & Company, McKinsey Global Private Markets Review 2023: Private Markets Turn Down the Volume, March 2023

2 Hamilton Lane, 2023 Market Overview, March 2023

3 Managers with funds raised in the trailing 10 vintage years 20 years ago as of November 2020 and managers with funds raised in the trailing 10 years ago as of March 2023

adverse impact on achieving the desired outcome. As such, it is imperative to identify and access managers who are accomplished investors with the potential to generate superior returns and construct portfolios around them.

Exhibit 2: IRR by Vintage Year[4]



Operational due diligence

Operational due diligence (ODD) is a key component of the overall investment selection process for private market funds. It is dedicated to evaluating the business, compliance, operational, and IT risks of managers being considered for investment with an eye to helping investors avoid the pitfalls that can expose investors to losses, operational and or reputational risks. It is of particular importance given the illiquid nature of private market investments and can help investors understand the additional risks to a manager's businesses beyond the investment risks and to make a more holistic assessment of managers' capabilities.

The key areas that should be analysed in an ODD review include:

- **Business risks** – analyse a manager's business structure and vendor oversight, strategic planning processes including organisational growth, governance, management oversight and supervision, along with the firm's IT infrastructure and business continuity planning.
- **Operational risks** – it is important to examine the manager's trade processes from execution and counterparty oversight to settlement and reconciliation.
- **Compliance** – a review of this area considers the manager's compliance monitoring and reporting, personal trading policies, gifts and entertainment and conflict of interest policies, compliance with regulatory agencies, personal information security, and record retention.
- **Fund** – includes a review of the fund structure, offering documents, service provider relationship verifications, and background checks on key individuals.

Legal reviews and negotiating documents

Reviewing and negotiating legal documents such as private placement memorandums, subscription agreements, partnership amendments and side letters associated with making an investment in a private markets fund is a critical component of the overall investment decision-making process.

It is important to review all prospective fund documents that managers issue concerning an investment opportunity. Having detailed knowledge and expertise surrounding a variety of terms including appropriate restrictions around the strategy, key person provisions, alignment of interests (e.g., General Partner/GP commitments and carried interest allocations), allocation and valuation policies, management fees, and other expenses that can/can't be allocated to the fund, distribution waterfalls, etc. to ensure appropriate

[4] Cambridge Associates All Private Equity, Venture Capital, Growth Equity and Buyouts, Mezzanine and Distressed, years from 1981 – 2020. Returns shown net of fund fees and expenses. Returns shown through 2020 because in the early life of a fund, IRR may not be meaningful as the fund is still in the investment period and therefore IRR does not truly reflect performance of the fund. Returns for more recent fund vintages may be lower than the returns shown above, and IRRs are more likely to be negative. For illustrative purposes only. The returns shown above correspond to alternative investment products managed by third-party managers. They do not represent the actual investments of the Fund, Russell Investments, or any of its other clients. Past performance is not indicative of future results.

alignment with fiduciary duties and responsibilities. This process also includes having a thorough understanding of current market terms and conditions associated with private market investments to ensure investor interests are protected.

Monitoring and reporting

Once investments have been made there also needs to be additional consideration given to ongoing monitoring and reporting of a private markets portfolio. This requires a variety of resources and systems to be able to monitor, track and provide effective oversight including:

- **Monitoring**: post-close investment monitoring, annual meetings, participation in limited partner advisory committees
- **Reporting**: data collection and aggregation, including capital commitments, capital calls, distributions, and calculation of various return metrics, i.e., IRRs, total value of paid in (TVPI) and public market equivalent (PME)

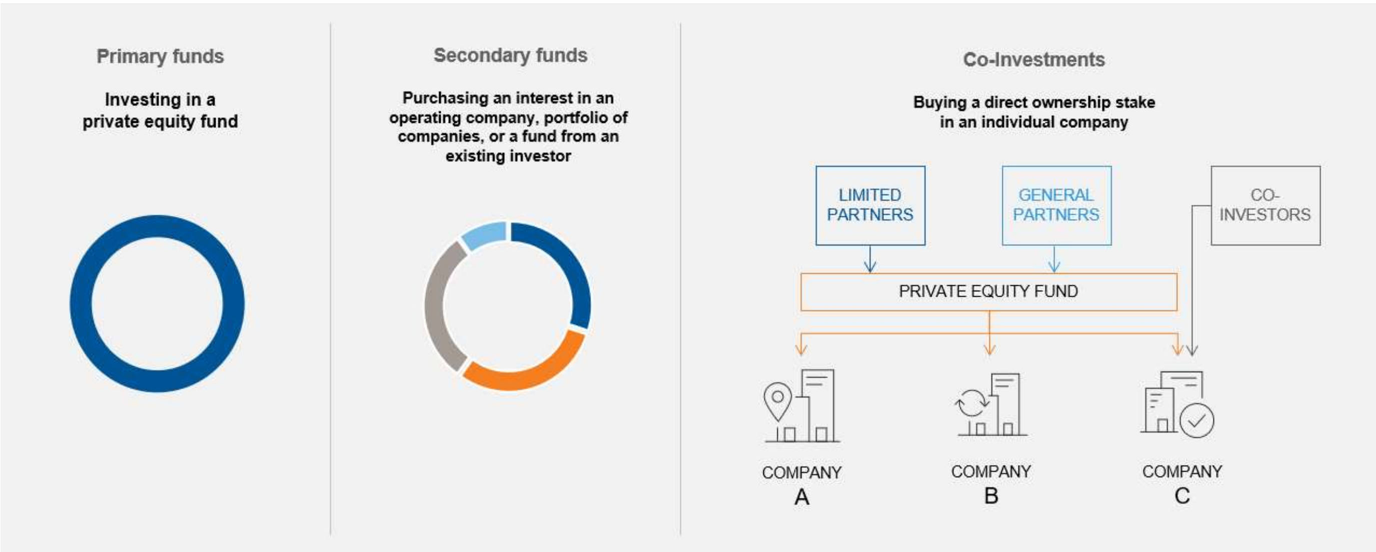
How to invest

Do-it-yourself or outsource to a fund-of-funds

Building a private markets portfolio can be achieved in one of two ways. Firstly, hiring in-house investment professionals to execute an investment process required to build a program is one option. While this can be an attractive option for some investors, there are costs associated with hiring investment professionals, manager selection due diligence, internal monitoring and reporting systems, legal expenses, etc. Another approach is to gain exposure through a FoF. A FoF is a pooled or segregated investment vehicle that is professionally managed whereby all investment (i.e., manager selection, portfolio construction, ongoing monitoring) and non-investment (i.e., ODD, legal reviews, reporting) functions are outsourced to a third-party firm. In this case, the burden of building and maintaining a private assets program is taken off the investor, allowing them to achieve access to a well-diversified portfolio even with relatively small commitment amounts.

Access points

The three principal ways of accessing private markets are as follows:



As the private markets investment universe has evolved over the last 20 years, the importance of secondary funds and co-investments has grown. That said, the level of expertise and resources required to successfully source, underwrite and structure secondary and co-investment opportunities is beyond the scope of all but the largest and most experienced investors. As such, utilising a FoF can provide an investor exposure to all three access points.

Portfolio construction

Private markets solutions are designed with consideration of an investor's top-down strategic goals and existing total portfolio exposures. Inputs to the portfolio construction process include risk and return objectives, liquidity considerations and a desire to gain exposure to certain investment themes, sectors and or geographies.

While individual client circumstances and objectives may differ, we believe building foundational exposure to private assets begins with broad diversification across strategy, geography access point and vintage year.

Particularly for those investors who are in the early years of their programs, we think it is prudent to obtain meaningful exposure to secondaries and co-investments. This is driven by the fact that investors are exposed to negative returns in those early years, particularly with primary fund investments on account of the *J-Curve*. In private equity, for example, by allocating a meaningful component (40%-60%) of portfolios in secondaries and co-investments, an investor's capital commitments can be called more quickly, returned faster, and have the potential to enjoy positive performance early on.

While we don't believe in *timing* private equity commitments, we are of the view that considering current market conditions and opportunities, secondary investments with high-quality general partners (GPs) make sense, given that a key benefit of secondaries is reducing blind pool risk. As secondary funds invest in existing commitments, it is possible to conduct due diligence on these assets prior to investing. With this greater transparency into the underlying assets comes greater visibility into potential future performance, including near-term exits, pending asset write-ups, and positive inflection points. These all contribute to improving near-term performance outcomes for investors. In addition, if the global economy were to experience an economic downturn in the coming years, secondary investors would benefit from being able to purchase interests at greater discounts to net asset value than is the case today, therefore improving expected future returns.

The advantages of fund-of-funds within private markets

Why are FoFs attractive to investors?

Smoother return pattern

As illustrated in Exhibit 3 below, there is significant dispersion across private market strategies returns in any given vintage year. From 2007-2020 the average dispersion between the top and bottom-performing strategy has been 27.7%. Utilising a FoF approach that incorporates different strategies results in a smoother return pattern for investors. In addition to diversifying across different sub-strategies—i.e., buyout, secondaries, and venture capital—it is also important to pursue diversification over multiple vintage years given the long-term nature of the asset class. By investing across multiple vintage years, investors can reduce the risk of concentrating their investments in a particular economic environment associated with any given vintage year.

Exhibit 3: Private market strategies' pooled IRR comparisons by vintage year[5]

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	10-year horizon IRR*
11.2%	13.6%	18.9%	19.4%	21.3%	18.7%	20.2%	24.9%	23.4%	30.1%	32.2%	32.1%	43.8%	42.1%	18.2%
10.8%	13.6%	13.4%	15.2%	16.9%	17.3%	17.5%	23.2%	21.4%	27.8%	32.0%	30.8%	38.0%	40.2%	16.8%
10.1%	13.1%	12.7%	13.6%	16.7%	15.6%	16.7%	20.3%	20.6%	24.3%	30.3%	26.0%	36.0%	30.5%	16.6%
8.9%	11.3%	12.3%	13.5%	16.6%	15.5%	15.2%	18.5%	18.8%	22.3%	27.2%	25.3%	35.6%	29.7%	14.2%
6.3%	7.7%	11.5%	13.2%	14.9%	14.6%	12.3%	16.5%	14.8%	21.5%	19.9%	24.2%	31.1%	26.7%	14.0%
5.8%	7.6%	11.5%	11.4%	14.1%	13.7%	11.9%	12.8%	14.1%	15.1%	18.8%	19.5%	30.3%	26.0%	12.8%
5.3%	5.9%	11.1%	10.8%	11.8%	13.7%	10.7%	12.6%	13.1%	13.8%	18.4%	15.4%	28.3%	24.8%	12.8%
5.1%	4.8%	8.8%	8.3%	8.9%	13.0%	9.0%	11.1%	11.1%	11.3%	16.0%	15.1%	20.9%	22.8%	10.4%
3.6%	3.8%	6.8%	7.7%	5.8%	7.1%	6.8%	10.3%	9.8%	9.9%	11.2%	13.2%	12.5%	16.5%	8.8%
2.3%	-3.5%	1.4%	-5.2%	2.7%	1.4%	6.6%	6.4%	7.3%	9.6%	8.2%	8.6%	11.1%	8.7%	4.7%

Buyout · Funds of funds · Growth-expansion · Infrastructure · Oil & gas
Private debt · Value-add real estate · Opportunistic real estate · Secondaries · Venture capital

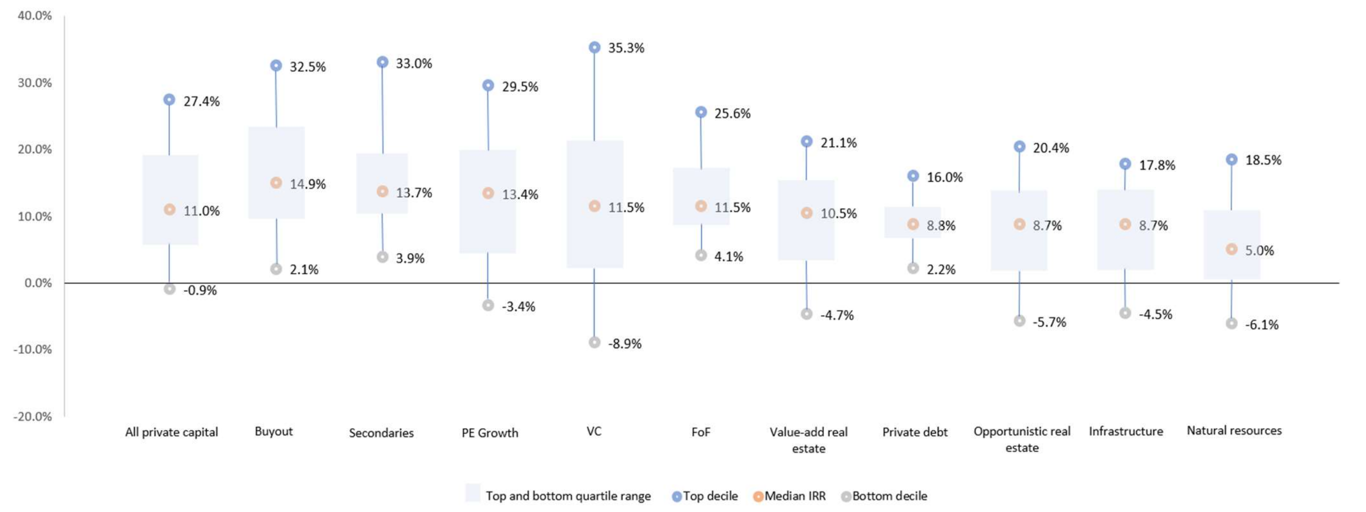
Manage downside risk through portfolio diversification

Utilising a FoF with a disciplined portfolio construction process can effectively manage downside risk. As shown in Exhibit 4 below, even FoFs in the bottom decile of performance did not lose money, and they delivered superior returns relative to other bottom decile managers across strategy type.

Access to more underlying managers, strategies and assets leads to a superior level of diversification and lowers reliance on a single strategy or fund to deliver returns.

For example, a single fund often only invests in 10-20 individual assets, whereas a FoF typically provides access to over 200 assets across different geographies and sectors.

Exhibit 4: Private, Closed-End Fund net IRRs by Strategy (vintage years 2002-2016)[6]



[5] Pitchbook, Quantitative Perspectives, U.S. Market Insights, Q1 2023
[6] Pitchbook, Quantitative Perspectives, U.S. Market Insights, Q1 2023

Securing an allocation to top-tier private market funds: By working with an experienced private markets investor with a strong industry reputation and access to top-tier firms, a FoF investor can directly benefit from these relationships through access to highly sought-after funds that would not otherwise be available. The experienced private markets investor will also have the requisite resources to continuously monitor managers and funds around the world, in order to identify attractive investment opportunities for inclusion in a portfolio. Experience and specialist knowledge is essential to selecting the best managers and products among the wide spectrum of opportunities in private markets at any time.

Cash flow management: Given the frequency of capital calls and distributions across a private markets' portfolio, a FoF can help to ease the investor burden when managing the underlying cash flows.

Reduces complexity: A key benefit of FoFs is that they remove the burden of additional complexity associated with private market investing from the end investor while allowing them to obtain the benefits of investing in private assets, such as access to a larger opportunity set and superior returns relative to public markets.

Access to specialist managers: We believe those managers who specialise in certain sectors (i.e., industrial, technology, consumer) or market segments such as small-mid buyouts are more likely to have clear areas of expertise relative to generalist managers. This specialist expertise directly translates to sustainable value creation opportunities across acquisition, business transformation and exit. Examples of these include proprietary networks to generate investment opportunities, operational and strategic initiatives to drive EBITDA growth, and maximising value upon the sale of portfolio company investments.

The bottom line

It is not surprising that investors are increasingly turning to private markets to improve their investment outcomes, given the potential for greater returns and accessing a larger investable opportunity set relative to the public markets. That said, building and maintaining a high-performing private markets portfolio requires specialist research, portfolio management, operational due diligence and legal resources that are not always found within in-house investment teams. Ultimately, we believe that for most investors, a FoF approach can help unlock the benefits of private markets. With over 50 years of experience in helping investors integrate private markets into their portfolios, Russell Investments is well-positioned to act as the *guiding hand* to help investors successfully implement a private markets program.

QUESTIONS?

Call Russell Investments at **020 7024 6000**
or visit **russellinvestments.com**

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