Building a Successful Private Equity Portfolio from Scratch: A Practitioner’s Guide

By Dean Roney, CFA
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P rivate equity (PE) traditionally has been primarily an institutional (only) investable asset class. Recently, however, other accredited investors, such as family offices, have contributed increasing amounts of capital. This article discusses key considerations for the investment professional who strives to build a PE portfolio from scratch. It also provides portfolio management insights for the seasoned private-market investment professional, including when to consider a private benchmark as a measurement for the PE portfolio.

TIME HORIZON

First and foremost, one needs a time horizon of several years to best gauge how the investment returns on a newly constructed PE portfolio compare to portfolios of other investors. Why so long? Many factors contribute to this being the case, including the following considerations:

Vintage-year risk. Building a PE portfolio of primary fund investments from scratch should entail similarly sized annual commitments to funds to diversify the vintage-year risk within the portfolio. The assessment of vintage-year risk recognizes that timing can impact PE fund performance because investment returns are influenced by macroeconomic cycles. In fact, attempts to forecast market conditions over a prolonged period often are considered futile. Making consistent annual commitments to a PE portfolio helps to reduce the vintage-year risk within the portfolio (Shah and Esipovich 2019).

Investment returns follow a J-curve pattern. The typical PE fund has a drawdown period of roughly three to five years (Diller et al. 2009). Invested capital will be returned via distributions to investors over the life of a fund, and the typical term for a PE fund is at least 10 years. Simply put, the first few years generally entail negative returns on invested capital before the fund advances rapidly toward achieving its targeted net return. New fund commitments are necessary every year to maintain exposure to the asset class. Because building a PE portfolio from scratch generates a negative net internal rate of return (IRR) in the first few years, expectations must be set accordingly.

Relative performance measurement. Cash flows in PE are contingent upon the general partner’s activity regarding the investments (portfolio companies) within the fund. When an investment is sold (or exited via an initial public offering) by a fund, its value is impacted because the sales price usually deviates from the formerly estimated value (carrying value). Each exit, therefore, can increase or decrease the return on both the individual investment and the overall fund.

Until the PE portfolio’s net cash flows align with the industry’s, return comparisons to other investors’ PE portfolios cannot accurately depict performance.

From 2011 to 2018, the PE industry was a net distributor of funds back to investors (Lykken 2019). If a starting-from-scratch portfolio has more money invested into the portfolio than coming out through distributions over the same time period, it is at odds with the overall cash flows taking place within the industry. Consequently, it challenges any meaningful conclusions drawn from relative performance analysis due to the deviation between exit values versus carrying values noted above. With this in mind, investors must exercise patience before comparing their overall performance return on the entire PE portfolio to returns reported by similar investors in the industry.

PORTFOLIO CONSTRUCTION

The composition of a PE portfolio often can be categorized by investment strategy, geography, manager or fund size, and industry concentration. Therefore, decisions must be made concerning portfolio positioning with respect to these components. The following are elements to consider within a PE portfolio:

Investment strategy. Starting a PE portfolio from scratch requires decisions about how much to invest in venture capital or growth equity, leveraged buyout, and debt (direct, opportunistic, mezzanine) strategies. Prudently, one should establish target ranges of exposure to each strategy type, which always can be fine-tuned later by realigning ranges more precisely within a strategy.
For example, ranges could be set for early-, mid-, and late-stage exposure within the overall allocation to venture capital, if there is value in doing so for the portfolio. When setting target ranges, consider mimicking the size of the investable opportunity set(s) in each strategy. PE is dominated by capital flowing into and out of leveraged buyout strategies versus other strategies. Consequently, one might consider the following ranges: venture capital and growth equity (10–20 percent), leveraged buyout (50–70 percent), and debt strategies (15–25 percent).

**Geography.** Geographic diversity or exposure also requires establishing target ranges. Globally diversifying exposure has innate merits because different economies experience different levels of growth at different times. Akin to the leveraged buyout segment attracting the most capital in the strategy component, North America unsurprisingly attracts the most PE capital in the international market. Therefore, the following geographic ranges could be considered: North America (55–70 percent), Europe (15–30 percent), and Asia and Emerging Markets (10–25 percent).

**Investment manager or fund size.** The segmentation of fund size(s) also can impact the return on a PE portfolio. When PE funds come to market, generally they are classified as large ($5 billion or greater), mid-market ($1 billion to $5 billion), or small ($1 billion or less). Diversification is recommended once again in order to avoid putting all the eggs in one basket. Manager selection ultimately constitutes the main driver of returns for a PE portfolio, but one can and should supplement with diversification via fund size by spreading investment across fund-size categories.

**Industry concentration.** Deliberate diversification among the industry-type exposures is also important. Although manager selection remains the most important decision, be mindful of disproportionate exposure to a particular industry. Track portfolio industry concentration exposures by categorizing the individual portfolio companies within the fund(s) by industry-type. In a well-diversified PE portfolio for a U.S.-based investor, the concentration of industry exposures should loosely resemble the industry exposures within the S&P 500. For illustrative purposes only, let's look at one of the Global Industry Classification Standard’s (GICS) industry types, Information Technology (IT), which comprises roughly 23 percent of the S&P 500. If a PE portfolio has IT exposure well above (e.g., more than 30 percent) or well below (e.g., less than 15 percent) this S&P percentage, exposure to IT should be considered when evaluating future investment managers. In other words, how much do they typically invest—or not invest—in IT?

Exposure to PE, through commitments made to primary funds, is not instantaneous like it is for stocks and bonds. Commitments to PE funds are invested (“called”) gradually over several years, and a fund might be making distributions back to investors over that same time period as well. As a result, achieving target exposure to PE requires an overcommitment of capital to the asset class. Much research has been published about re-commitment strategies in PE, but, from the perspective of “starting from scratch,” using a 30-percent over-commitment to achieve the desired strategic allocation to PE presents a good starting point (Zwart et al. 2012). Keep track of how much in total commitments has been called (funded) versus not called (unfunded) to gauge the proximity to the target allocation for PE and to inform how much in additional commitments is needed over time.

**MANAGER SELECTION**

The common mantra among industry professionals espouses that the PE asset class is all about manager selection. An untold number of research papers and articles have been published on this topic. Accordingly, discussion about the importance of manager selection is easily accessible from readily available information sources. To summarize, the importance of manager selection in PE primarily follows two rationales:

- The gap between the best- and worst-performing managers is typically wide.
- Managers that have performed well in the past tend to perform well going forward.

If these two assumptions hold true, how do they impact investment manager selection (McGrath 2017)? Unfortunately, not all managers may be investable for the pool of capital that one represents. Large institutional investors typically can easily commit tens or even hundreds of millions of dollars of capital at a time to a fund. This is because the size of one’s capital pool proportionately impacts the ability or interest of the general partner (GP) to accept capital. Logically, a GP desires a diversified investor base but also seeks to limit the number of limited partners (LPs) accepted into its fund offerings. Doing so allows the GP to better manage its internal resources for information reporting and investor relation activities.

So, what does this mean for a start-up PE portfolio? Fortunately, plenty of investment managers are soliciting investor capital for fund offering(s) that will gladly accept new LPs. It can be a double-edged sword, however, because firms may be more receptive to new LPs when falling out of favor among larger investors that give preference to more highly sought-after funds.

How does an investor manage this conundrum given the consensus that successful investing in PE is all about making good manager selections? According to data compiled by Bloomberg, 2019 vintage-year funds raised approximately $465 billion (Karsh and Robertson 2020). Opportunities in

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the PE marketplace, therefore, remain abundant. Consequently, many primary fund offerings across strategies, geographies, fund sizes, and industry concentrations warrant serious consideration for capital investment. Several PE industry news providers compile lists of all the firms currently fundraising. Procuring the investment opportunity set thus remains easily obtainable.

Successful PE investment manager selection requires both artistic and scientific skill. Because artistic talent is considered more of an individual soft skill that one develops over time, new investors are better served by focusing on the scientific element, which relies on sound due diligence techniques. Although a step-by-step guide for performing due diligence on investment management firms and their fund offerings lies beyond the scope of this article, here are a few due diligence topics to be mindful of when performing your own analysis:

Never overlook the relative performance of the fund series under review. Seek out those firms that consistently have generated first- or second-quartile performance against the industry benchmark for multiple offerings in their fund series. For example, one might think twice about investing with a firm that may have only one successful fund among its offerings. A long track record of favorable results reinforces the belief that managers that have performed well in the past tend to perform well going forward.

Search for a satisfactory level of alignment of interest between the GP and the LPs. Approaches include identifying how much the GP chooses to invest individually in the fund offering and whether it is proportionately significant. Thoroughly review the fund terms contained in the limited partnership agreement (LPA) and decide if the terms align to the general market or whether they overly favor the GP (at the expense of LPs). Outside assistance may be required for this depth of due diligence. Contracting with a reputable law firm, familiar with reviewing LPAs, may be in order.

Assess the firm's personnel profile. How much turnover has taken place since the last fund offering (three or four years ago)? Make sure that the investment professionals responsible for generating positive returns in the past remain at the firm.

Conduct an on-site meeting, or, at the very least, hold one via videoconference. Personal interaction with the investment professionals at a firm can and should influence the decision-making process. Remember, the relationship with this firm and its personnel most likely will continue for 10 years or longer. Accordingly, a requisite level of transparency offered by the GP and sufficient time and attention provided to the investor are both essential. Manager selection is a nuanced process, but as one gains industry experience as a PE investment professional, instinct can become a more integral element of the decision process.

PORTFOLIO MONITORING
An established PE portfolio requires monitoring. To summarize, start-up for a PE portfolio entails the following process: (1) educating the investor base (that is providing the capital) so that they anticipate it will take several years before performance returns begin to materialize; (2) setting target ranges for portfolio diversification; and (3) selecting fund commitments with your highest conviction investment managers. But what comes next? Just like any other investment portfolio, a PE portfolio requires close monitoring to evaluate whether it is meeting performance expectations. PE industry data and service subscriptions are available to help assess how the individual funds in the portfolio are performing on both an absolute and relative basis. An accounting system, either internally developed or provided by an external servicer, is imperative to properly account for the cash flowing into and out of the PE portfolio. Proper records of fund cash flows are necessary to calculate accurate investment performance for each fund, both individually and at the aggregate portfolio level.

Once a fund reaches maturity for comparative analysis, benchmark providers publish quartile rankings for various funds, based on vintage year and strategy. Burgiss, Cambridge Associates, and Preqin are some of the most common benchmark providers in the industry. These providers only evaluate funds that have existed for at least three years because investment returns for younger funds often are negative and are not suitable for comparison.

Quartile rankings most commonly provide comparative data on three specific performance metrics: net internal rate of return (IRR), net multiple on investment capital (MOIC), and distributions to paid-in capital (DPI). These terms are defined as follows:

Net IRR: The net IRR is the net return earned by investors over a particular time period, calculated on the basis of cash flows to and from investors, after the deduction of all fees, including carried interest.

Net MOIC: The net MOIC is calculated by dividing the fund’s cumulative distributions plus residual value by the paid-in capital.

DPI: The DPI is calculated by dividing the fund’s cumulative distributions by the paid-in capital.

Tracking these three metrics on the funds within a PE portfolio will go a long way toward gauging how the funds are performing among their peer set(s). In addition, these metrics will shed light on the effectiveness of manager selection over the years, be it positive or otherwise.
CONCLUSION
It is a daunting task to start a PE portfolio from scratch. The skilled practitioner and the capital provider for the investments, however, must agree initially on their expectation about when to begin evaluating the portfolio on a comparative basis. Agreement is imperative because each PE portfolio is unique with respect to its composition and its underlying investments. The only way to draw meaningful comparisons against other PE portfolios is to compare a mature portfolio against a body of other mature portfolios. It may take three years to be able to meaningfully evaluate relative performance of a single fund, but it may take several more years to measure the relative performance of an entire PE portfolio.

It takes many years for the annual cash flows of a new PE portfolio to mimic the cash flows taking place in the industry as a whole. An individual PE portfolio needs to be at least directionally the same as the market in aggregate. Only then can meaningful comparisons be made regarding the relative performance of an individual PE portfolio versus those of the market.

Using a public equity benchmark plus a spread (illiquidity premium) as a portfolio-level benchmark is a widely evaluated and researched topic that will not be explored here. Using some sort of portfolio-level performance measurement, however, can provide a baseline of sorts. Therefore, while waiting for the “starting from scratch” portfolio to mature, one may want to consider using a public equity index plus a spread (e.g., 200 basis points) to get a general idea of how the portfolio performs against a fully liquid investment alternative.

PE market participants are bright and driven, which can make for enriching careers, both professionally and intellectually. Using the above portfolio constructs, which have generated favorable results in the institutional public pension plan space, may help efforts to build PE portfolios that will stand the test of time.

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ENDNOTE
1. The model PE portfolio is assumed to be composed solely of primary fund investments for the sake of this commentary and does not include secondary investments or fund-of-funds investments.

REFERENCES