Marquette Associates

The Four Virtues of Private Equity

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Contents

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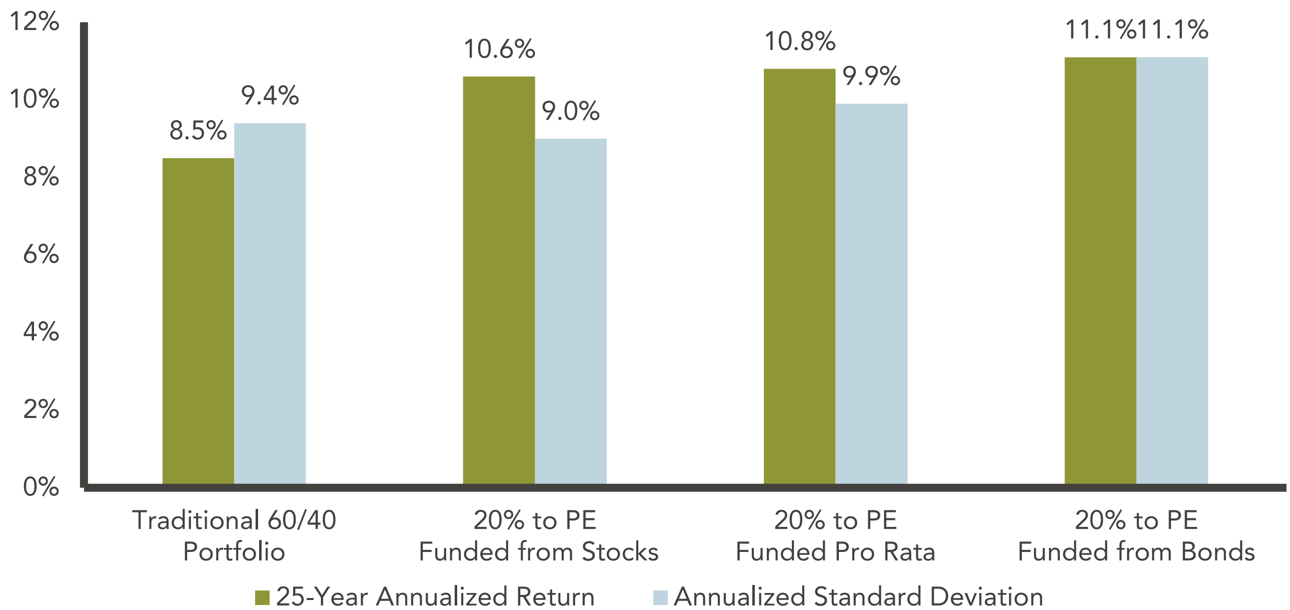
In classical philosophy we are taught that there are four virtues of mind and character: prudence, temperance, fortitude, and justice. Given the uncertainty that lies ahead in 2023, it is prudent (pun intended) to revert back to these virtues — as they relate to private equity — to outline a framework that may help investors effectively navigate the market.

PRUDENCE: The ability to discern the appropriate course of action

Investors and fiduciaries are faced with a multitude of choices when it comes to investing in private equity. At the highest level, the long-term nature and illiquidity of private equity investments often determine if the asset class is a viable option for an institution. From there, if the goal is growth over the long term with reduced short-term volatility, private equity may be considered. Institutions willing and able to invest in private equity typically allocate anywhere from 5% to 20% of their portfolio to the asset class. Exhibit 1 compares the risk and return characteristics of a traditional 60/40 portfolio to one with a 20% allocation to private equity.

Exhibit 1: Adding a private equity allocation to a traditional portfolio may enhance returns while reducing volatility

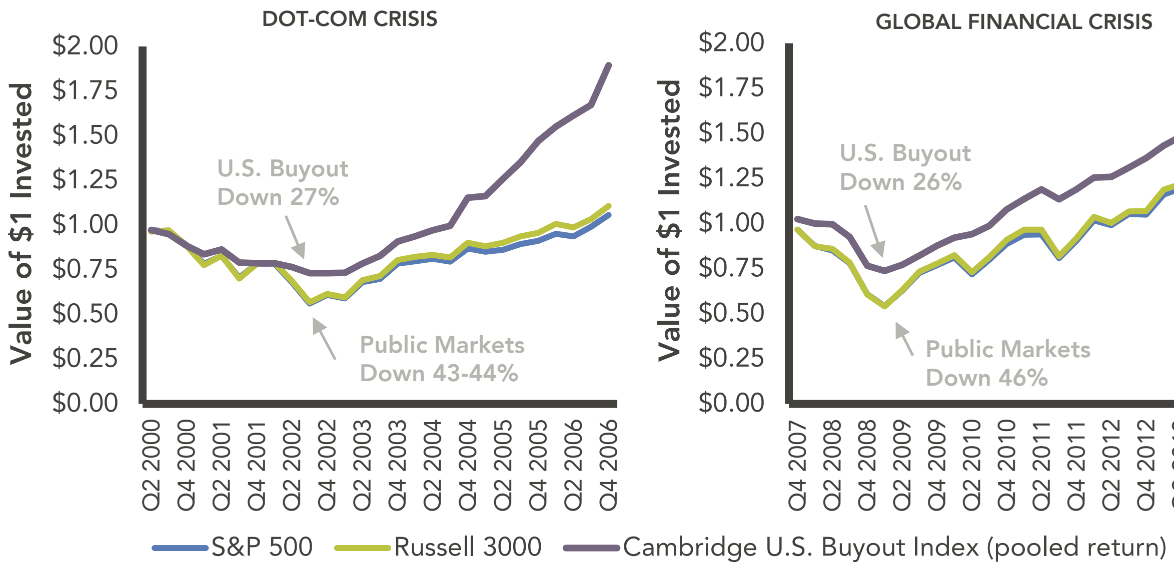


Source: eVestment as of June 2019. For illustrative purposes only. June 1994 – June 2019. Data through 2019 provides the most sufficiently seasoned private equity returns. Based on S&P 500 monthly returns, Bloomberg Aggregate Bond Index monthly returns, and Cambridge US PE Index quarterly returns

An asset allocation study will illustrate how a portfolio may perform over the long term, with stress-testing of the assets in periods of economic and market downturns, such as the Dot-Com Crisis of the early aughts and the Global Financial Crisis seven years later, as shown in Exhibit 2 on the following page. The U.S. private equity index fared better than public equity indices with less volatility during both drawdowns and outperformed over the long run.

Subsequent to an allocation determination, a commitment pacing study can be performed which will determine how much capital should be committed each year in order to achieve a target allocation over a predetermined number of years.

Exhibit 2: Private equity has historically experienced less significant pullbacks with quicker recoveries in times of distress



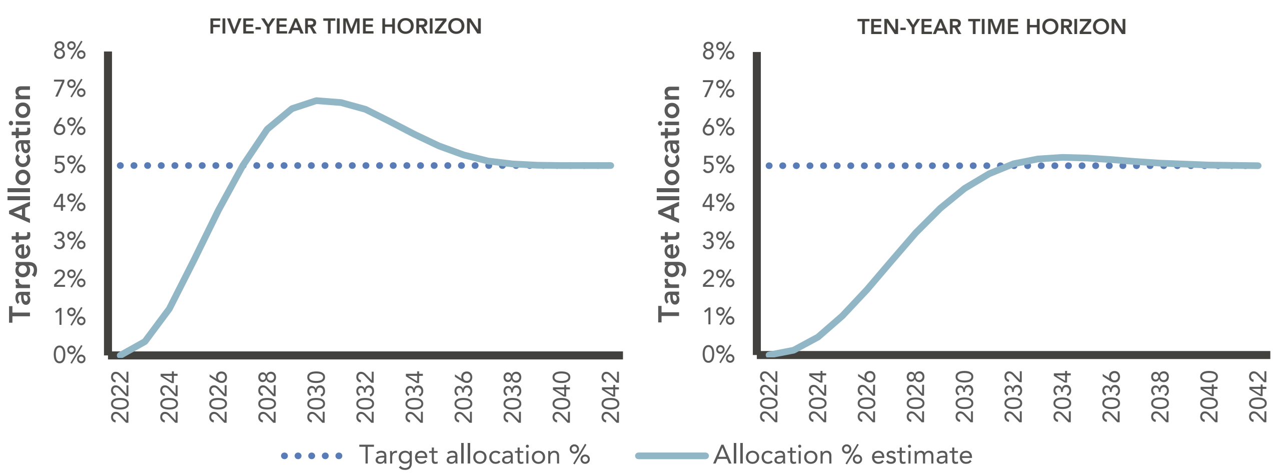
Source: Bloomberg, Cambridge Associates, Neuberger Berman

This leads us to virtue number two, temperance.

TEMPERANCE: The practice of discretion, restraint, and moderation

Investors with below-target positions in private equity may be tempted to pull forward allocations in order to catch up. Exhibit 3 below illustrates the modeled allocation growth over a five-year and ten-year time horizon for a portfolio starting with a 0% allocation and targeting a 5% allocation. Over the shortened five-year time horizon, an investor may temporarily over-allocate to the asset class and increase illiquidity risk within the portfolio. Over a more standard ten-year horizon, the growth of the private equity portfolio is much smoother, although it will take longer to achieve the 5% allocation.

Exhibit 3: Allocating to private equity over a longer time horizon can mitigate short-term over-allocation risks

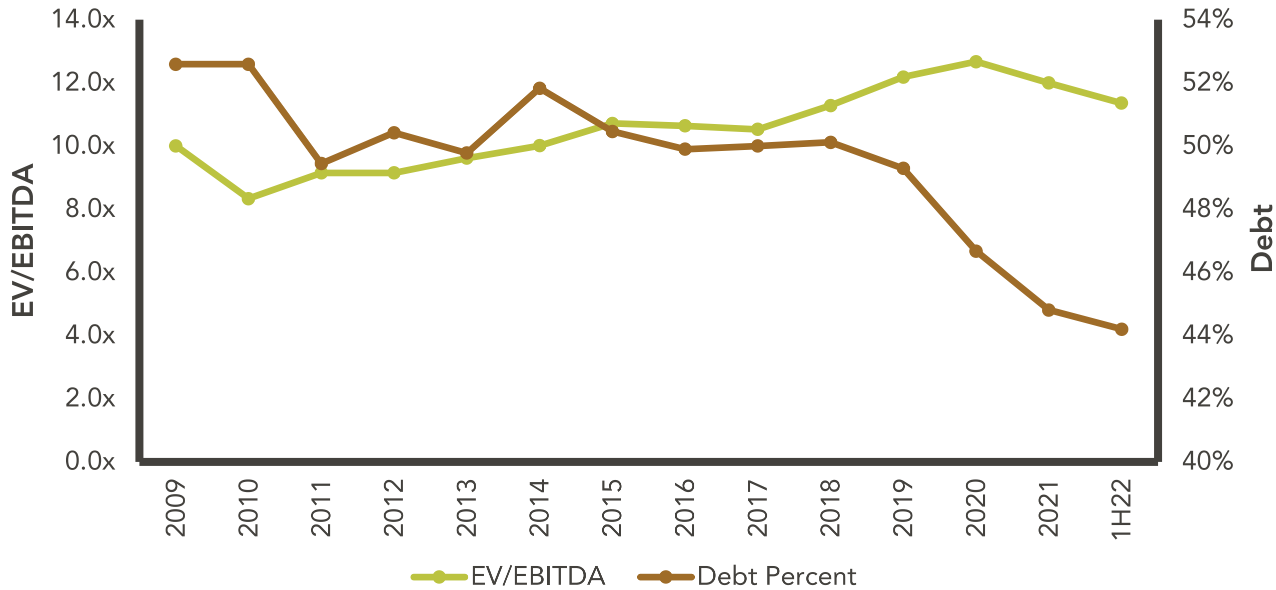


Source: Pitchbook Cash Flow and Commitment Model. For illustrative purposes only. It cannot be guaranteed that a portfolio will precisely mirror this model.

For investors with a program in place who are experiencing a period of increased allocation due to the denominator effect — when the overall value of a portfolio decreases disproportionately to a specific asset class, resulting in a short-term over-allocation — there may be an instinctual urge to pause or slow the pace of commitments. However, pacing should not be a function of market movements. Consistent pacing ensures there is proper vintage year diversification and mitigates any temptation to time markets. Unless there is a fundamental change — such as unexpected capital inflows or outflows or a change in strategic asset allocation — pacing should remain as consistent as possible, with periodic monitoring.

It is also important for private equity managers to embody the virtue of temperance. Managers may have demonstrated this by practicing restraint when others have not, as the amount of private equity capital raised has continued to grow and investment period deadlines loom. Managers who have maintained discipline regarding purchase price multiples and the amount of previously-inexpensive debt used in financing a deal may expect to find their portfolio companies better positioned to weather the potential 2023 storm than those who did not.

Exhibit 4: Though purchase price multiples have increased modestly, middle market private equity transactions are increasingly being financed with equity as opposed to debt



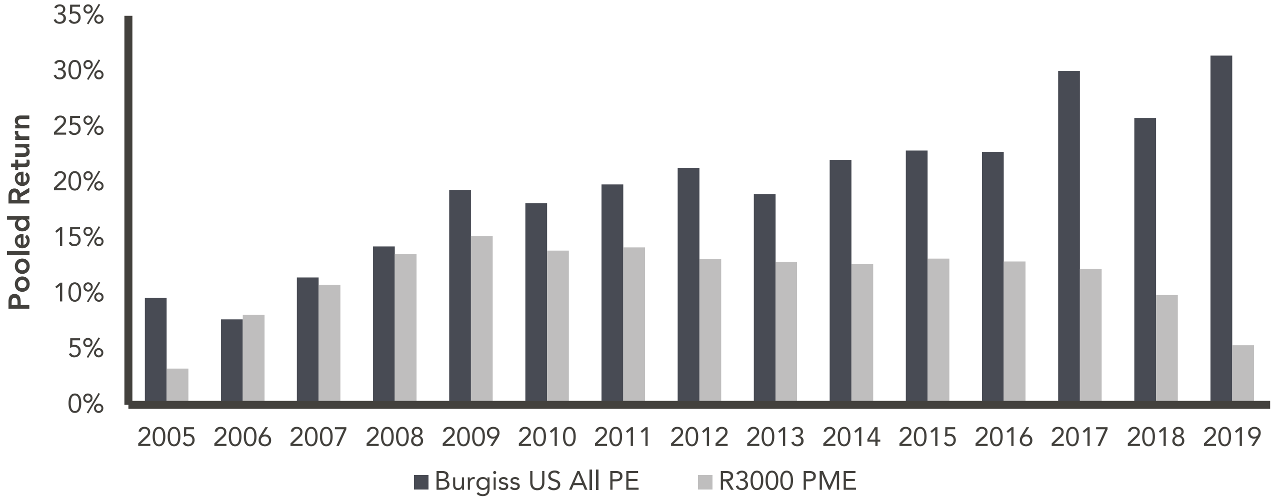
Source: Pitchbook, 2Q2022 US PE Middle Market Report

Enter virtue number three, fortitude.

FORTITUDE: Strength, endurance, and the ability to confront fear

Investor fortitude is being tested in today's markets. But as with all asset classes, Marquette encourages investors to maintain discipline and remain invested through periods of stress, in accordance with strategic asset allocation targets. As discussed in a recent Chart of the Week, "When Not to Quit," there are drawbacks to market-timed pacing adjustments. In the month following that piece's publication, the S&P 500 rose more than 5%, altering the previous month's denominator effect. As noted, private equity is a long-term investment, and making long-term decisions based on short-term and temporary market movements can have unintended consequences. To reiterate the conclusion from "When Not to Quit," adjustments to annual capital commitments can ultimately result in an under-allocation to private equity and potentially underperforming portfolios for several years as public market allocations snap back. As shown in Exhibit 5, in the years following the GFC (2009–2012), private equity returns exceeded those of comparable cash flows invested in the Russell 3000 index by 400–800 basis points, a delta that only further widened in the years to come.

Exhibit 5: During the years after the GFC, private equity continued to outperform



Source: Pitchbook as of June 30, 2022; Burgiss North American All Private Equity Public Market Equivalent, Pooled Returns. Pooled internal rate of return (PIRR) is a method of calculating the overall IRR of a pool of funds by combining their individual cash flows. PME, or public market equivalent, refers to the Long-Nickels PME which matches cash flows in and out of a private equity portfolio into a public market index, matching dates of in/out flows.

Moreover, should fear dictate certain investor behaviors, a broader pullback in commitment pacing could increase competition for investor dollars. Increased competition can lead to enhanced bargaining power for those investors able to stay the course and deploy capital.

We arrive at our fourth and final virtue, justice.

JUSTICE: Fairness

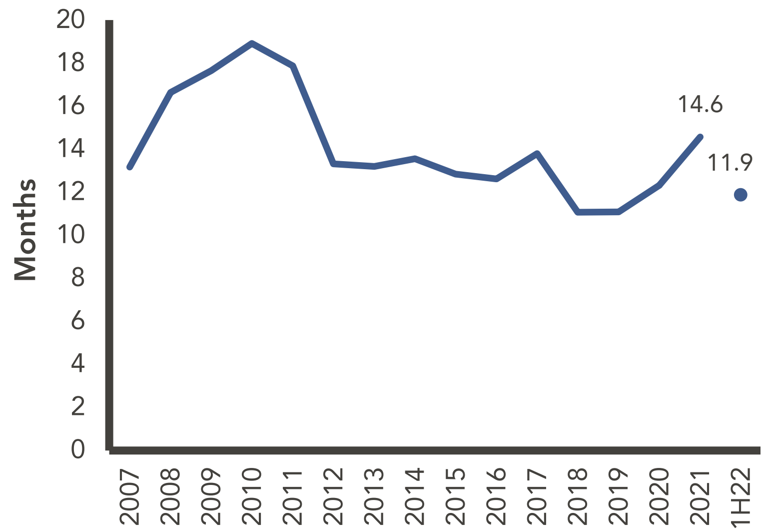
In the realm of private equity, justice is expressed as an alignment of interests between managers and investors, visible in the terms within the limited partnership agreement ("LPA"). In addition to negotiating a first close management fee or carry discount, there are other terms that can result in additional monetary benefit to investors, such as organizational expenses borne by the fund or transaction fee offsets. Trends in terms can be difficult to quantify as they vary amongst sub-strategies, fund size, and in certain cases, how many funds a general partner has raised.

Investors do have a "Themis" on their side. In 2002, the Institutional Limited Partners' Association ("ILPA") was formed primarily as a networking group for investors and has evolved into a global organization with over 600 members across 53 countries. ILPA serves as a mechanism for thought leadership and education in addition to being at the forefront of advocacy for investors. In 2020, ILPA began publishing results of a survey the organization conducts concerning trends in LPA terms. The 2021 survey found that while management fee rates have remained stable (1.5–2.0%), partnership and organizational expenses have continued to rise, and have begun to include expenses that have historically been covered by management fees. These fees have increased 123%[1] since 2011. One of the bright points of the survey findings was that transparency into what is being including in these fee categories is improving.

[1] ILPA, Key Findings *Industry Intelligence* 2021 Report, "What is Market in Fund Terms?"

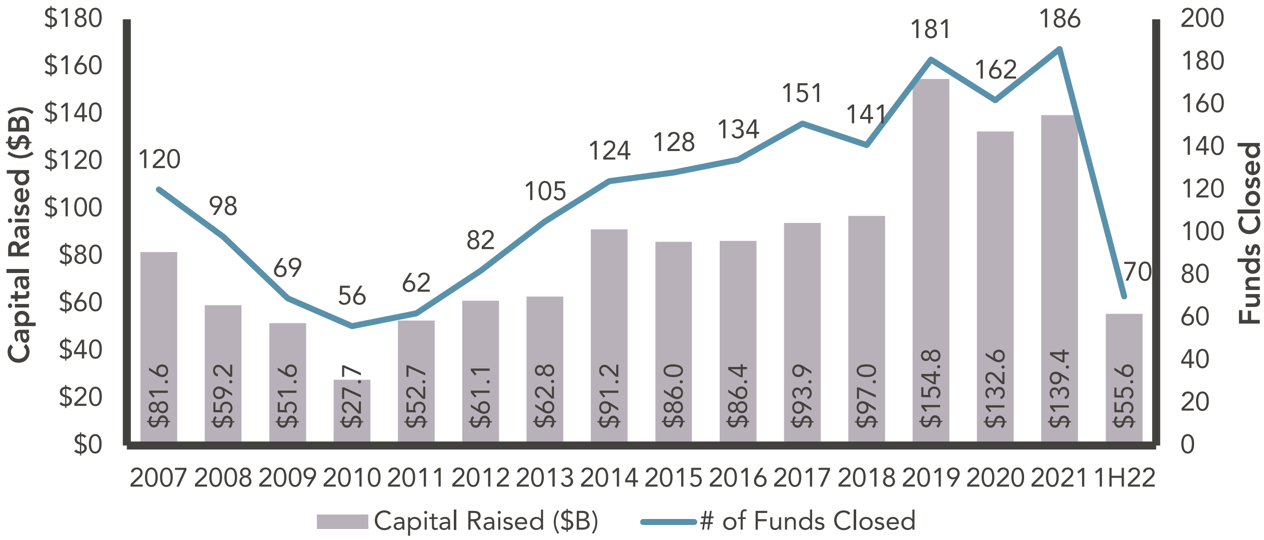
From here, the bargaining pendulum may be swinging in investors' favor. We have witnessed a steady increase in time to close since the 2018 trough of 11.1 months to a recent peak of 14.6 months in 2021, as well as a pullback in capital raised in the first half of 2022. Though there was an acceleration in time to close in the first half of 2022, anecdotally, we have seen both first and final close dates continue to push further out throughout the year. To the extent these are signs that allocators are growing skittish, there may be increased opportunities for investors to negotiate more favorable terms.

Exhibit 6: Fundraising timelines steadily ticked up from 2018 through 2021



Source: Pitchbook, 2Q2022 US PE Middle Market Report

Exhibit 7: A slowdown in capital formation may create bargaining power with managers



Source: Pitchbook, 2Q2022 US PE Middle Market Report

CONCLUSION

Difficult market environments like 2022 (stress) test investors, but we believe that if these virtues are upheld, private equity portfolios should prove resilient over the long term. Prudently discerning whether to invest in the asset class, practicing restraint when building out a thoughtful program and pace, conjuring the strength to endure market downturns, and negotiating equitable terms as appropriate should serve investors well as the cornerstone virtues of any successful private equity program.

Stay virtuous, fellow investors.

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About Marquette Associates

Marquette was founded in 1986 with the sole objective of providing investment consulting at the highest caliber of service. Our expertise is grounded in our commitment to client service — our team aims to be a trusted partner and as fiduciaries, our clients' interests and objectives are at the center of everything we do. Our approach brings together the real-world experience of our people and our dedication to creativity and critical thinking in order to empower our clients to meet their goals. Marquette is an independent investment adviser registered under the Investment Advisers Act of 1940, as amended. Registration does not imply a certain level of skill or training. More information about Marquette including our investment strategies, fees and objectives can be found in our ADV Part 2, which is available upon request and on our website. For more information, please visit www.MarquetteAssociates.com.