Get In Where You Fit In

Although it seems like private assets investing is at the height of its popularity with ubiquitous mentions across social, economic, financial, and cultural media, many institutions, entities, and individuals still hesitate to take the plunge. The most common reasons for the hesitation to enter this asset class that seems to be enveloping the world are a lack of understanding of its mechanics and a general skepticism about its promises. As an individual who navigates the moving pieces and interrogates the prospects of private assets investing, I empathize with the cautious stragglers. However, I fully believe in the positive attributes of private assets investing and have formulated what I think is a commonsense/logical approach to easing one's way into this alternative asset class.
To begin, some basic groundwork has to be laid - this involves the prerequisite acceptance of a few nuances which include relatively high illiquidity, relatively higher management fees (compared to other asset classes), acclimatization to the cadence of capital calls and distributions, and some degree of valuation ambiguity (at least until the exit of an asset). Once these aspects become engrained, you are ready to embark on your maiden voyage filled with landscapes of IRRs, vistas of multiples, and seascapes of unrealized and realized returns.

Additionally, before we get into the meat and potatoes of putting money to work into private investment vehicles, some key decisions have to be made. Important questions such as: "What portion of your portfolio do you want to allocate?" and "How will you be funding the allocation?" have to be answered. For the sake of conservatism and prudence, let's say 15% of an existing portfolio made up of 60% equity and 40% fixed income will be our starting portion and this amount will be funded from the liquid part of the preexisting portfolio. It should be remembered that for most private assets investments, exposure is not attained on day 1, so establishing a target allocation and knowing where this target will be funded from is mostly an academic exercise (at least in the beginning) necessary to maintain discipline and awareness regarding which holdings can be quickly liquidated to meet capital calls (the request (as needed) for capital by fund managers to execute transactions).

Now that the allocation amount and how it will be funded are determined, we can start perusing the buffet of possibilities. The options are vast and quite granular so becoming apprised of the idiosyncrasies of each is a valuable undertaking. A tried-and-true way of developing comfort in a particular private assets portfolio-building approach is to understand your risk aversion/tolerance as well as areas/sectors/industries in the world/economy/culture that you understand, are attracted to, or are curious about. The risk and understanding considerations indeed sound sophisticated while the attraction and curiosity factors appear to be naïve, but I am confident that all these aspects play an important role in building an effective and tailored private assets portfolio.

Risk tolerance can be categorized in a plethora of ways. Concentration, likelihood of losses (i.e. downside protection), degree of illiquidity, infancy of underlying holdings, credit worthiness/grade, investment manager reputation, etc., are all ways in which risk being taken can be measured. For example, investing with a manager who executes a very diversified portfolio carries lower risk than putting money with a general partner ("GP") that constructs concentrated portfolios. Likewise, investing in a manager that backs very young companies (i.e. a venture manager) can be viewed as riskier than committing capital to a fund that backs more mature companies (i.e. a buyout manager). Further expanding on the thinking around risk, it could be broadly stated that strategies that need longer timelines to complete investments and return capital, carry a higher risk than those that need less time for investments to mature and generate cash back to limited partners ("LPs"). Following in that vein, private assets credit investments, whether in enterprises or real assets (precious metals, commodities, real estate, land, equipment, natural resources, etc.) are generally viewed as being relatively less risky because there is usually a cash flow (yield) component to them as well as a terminal value in some cases. This is usually not the case with equity investments where investments are held for a relatively longer period and the ultimate reward occurs after value has been created and received at exit. Despite relentless investment manager promises of tactical and strategic arbitrage, the rules of finance generally stay impliable – alpha (excess return over benchmarks) tends to be higher with higher risk taken. The underlying motives (to add diversification to an existing portfolio, to experiment in a non-traditional asset class, to designate a portion of the portfolio as an alpha workhorse, or to match long-term organizational liabilities to a similarly long-tailed asset class, etc.) for entering into private assets investing will help determine the degree of risk exposure.

Now we delve into the chewy center by asking additional probing questions - What do you understand in this world? What are you curious about? What part of the economy do you believe is worth having exposure to? How close do you want to be to innovation? How scared are you of this private assets thing everyone is always talking about? What scares you about private assets investing? How do you feel about waiting close to 10 years to see realizations? What sectors do you believe to be resilient? Which geographies (local or international) have strong legs/momentum into the future? This spider web of questions can be endless, but there is some method to the madness. The goal here is to find the best vessel to use to ease a freshman private assets investor into this seemingly arcane asset class. The "buffet" characterization used earlier is an apt description of the investment options available within private assets because the permutations are quite awesome. However, despite the wide array of investment possibilities, it is imperative to state that thorough due diligence and rigorous selectivity should always serve as the true north.

With a hypothetical investor in mind, I will now go through a rabbit hole of investment choices in an attempt to illustrate how hospitable private assets investing is for all types of investors. Let's say our investor wants to build a portfolio that has some degree of liquidity (or downside protection) but also maintains the potential for some very high upside. Also, this investor is drawn to the healthcare sector because it makes up a healthy portion (~17%) of the US GDP and is an area where the investor's existing portfolio is deficient.

· a)For liquidity and downside protection, secondaries could be a good start – with secondaries, you get increased transparency, can backfill vintage year exposure, and receive cash back relatively quickly. But what type of secondaries? LP-led or GP-led, meaning do you want direct exposure to specific companies or broad discounted exposure to portfolios? Also, do you understand that alpha is somewhat capped with secondaries? b)Or maybe, you think that quickly getting capital back through cash-flowing hard/real asset investments such as core real estate, agriculture, timber, or energy is an astute path because investments are underpinned by tangible things. Once again, do you comprehend that absolute returns could be subdued because of the perceived inherent safety in these areas? Also, what tolerance do you have for the draconian commodity risk that governs some of these sectors? c)Credit investing is another way to reduce illiquidity and minimize the downside – this is because credit securities sit at the top of the capital structure and there is usually a set schedule for the receipt of capital as well as organized (legal recourse) avenues to handle impairments. Here too, the upside is truncated but confidence in potential return is relatively higher. In practice, there is the ability to mix and match all the aforementioned approaches – this means you could invest in a secondary fund that concentrates on credit investments, or you could invest in a real estate credit strategy, or you could invest in a fund that does it all(secondaries, credit, real assets, etc.) in one menu-driven vehicle or as part of a manager's flagship approach. The combinations are endless.

· For the healthcare exposure desire, the terrain is also quite vast. Do you want to participate in innovation (new therapeutics/devices), the service industry, digital transformation (reduction of inefficiencies through technology), lending to healthcare companies/institutions, the building of facilities, the rollup of facilities, etc.? a)Investing in a life sciences venture fund will give you exposure to cutting-edge innovation occurring with medicines and medical devices, but in most cases also opens you up to binary risks from clinical tests and FDA approval – the high potential rewards here match the risks. b) Healthcare services and facility rollup investments usually fall into the buyout realm – companies are more mature and operational capability is paramount – the potential reward is also potentially high (albeit lower than venture) here due to the many moving pieces that have to be connected and managed correctly. c)Digital transformation within healthcare which includes creating solutions to reduce waste, increasing the recovery outcomes of patients, streamlining payments and reimbursements, improving pharmacy and prescription processes, reforming clinical trial candidacy, testing, and analysis procedures, etc., tends to fall within the growth and venture investment realm - there is potential for high reward due to the equally high amount of risk inherent in these novel solutions. d)Lending within healthcare carries credit characteristics while; e) building healthcare facilities is reminiscent of a real estate approach. The permutations of healthcare investing (and quite frankly all other sectors) are only really hindered by one's imagination.

The above extremely summarized illustration of the varied possibilities available when starting a private assets portfolio attempts to mitigate any investor's hesitation to take that initial plunge. There are other means such as investing in funds of funds, private equity ETFs (investing in publicly listed private equity companies), or open-ended/evergreen funds to gain private assets exposure, but it should be remembered that for any chosen route, there will always be ramifications directly linked to the alteration the asset class's essence (illiquidity, black box, duration, etc.).

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