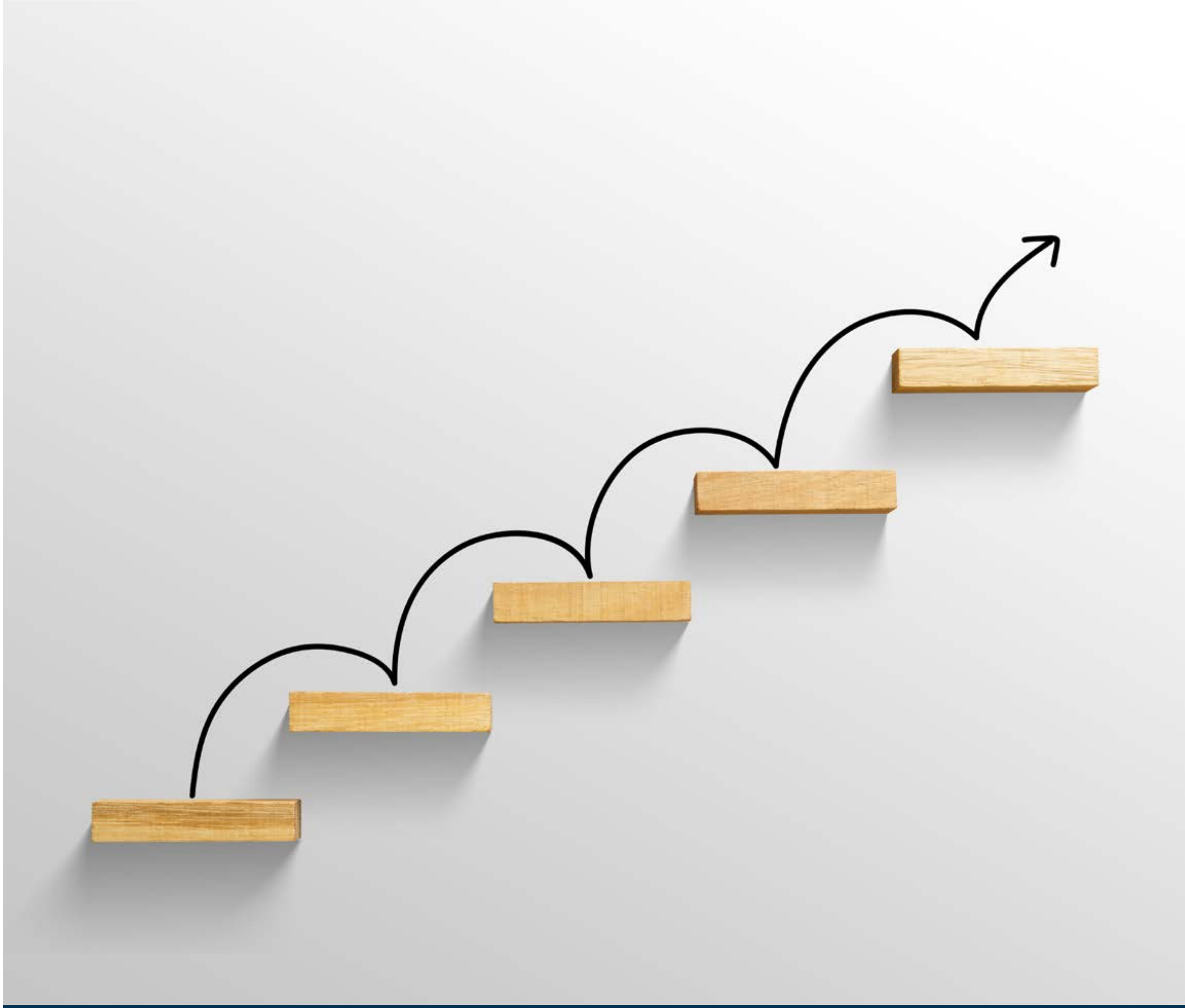

Succeed in Private Capital Investing

Key steps to building and maintaining
a well-structured private capital program.

commonfund

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Succeed in Private Capital Investing

"Allow for the possibility that the best of you is still inside you, waiting to emerge. Prepare the way, bit by bit."
— Lin-Manuel Miranda

Investors participate in private capital markets for two main reasons: they pursue increased investment return and portfolio diversification. This publication seeks to explain how we believe these joint objectives can be achieved.

Even well-informed investors who are experienced in publicly traded equities[1] *can be uncertain about private market investing. In addition to possessing good public market knowledge and expertise, they often need an effective resource to help them respond to questions from others involved in the investment process.*

In this publication, we focus on what we believe are the fundamental principles of private capital investing—principles to which we have adhered rigorously since our founding. These principles cannot eliminate risk, but following them consistently has proved to be a highly rewarding strategy for the institutions that invest with us.

1 General references made to public markets mean the equity markets where shares of ownership of companies are traded.

Learn

The first step of successful private capital investing is to learn what private capital is, what its risks and rewards are, and how it differs from public market investing.

Private capital provides investors with the opportunity to pursue higher long-term returns and greater diversification than are available through public securities markets alone. Private capital investments can be diversified by investment strategy, stage of development, vintage year (the year when a fund is raised or its first investment is made), industry, manager and geographic location.

Characteristics

Private capital investing has several characteristics that distinguish it from the public securities markets.

- Private capital markets are illiquid and inefficient relative to the public markets, a characteristic that gives astute managers the opportunity to gain access to and act on information about privately held companies that is not readily available to the public. In contrast, disclosure regulations from the SEC (and other regulating bodies) govern the release and use of material information by listed public companies, giving all public market investors equal access to such information.

- Another significant difference compared to public securities is time horizon. Because of their illiquidity, private capital investments typically have a much longer investment period than those in public securities. Often, a manager holds an investment for anywhere from two to seven years, building value over that time, before exiting the investment. This makes market-timing next to impossible in private markets.

- Perhaps most important, private capital investment managers are not simply financial investors. They often manage the companies in their portfolios actively, playing a material role in developing these companies' strategies and adding significant value over the investment period. This relationship is often strengthened by private capital managers' personal stake in portfolio companies, as they invest their own money in the funds they raise and thereby are directly affected by and concerned with the plans and actions they create and implement.

Investment Areas

Commonfund maintains ongoing investment programs in several private markets. This publication will focus on the traditional sectors of "private capital"—venture capital, private equity and distressed capital—as well as natural resources (which is sometimes classified along with real assets and/or other inflation-protection investments). Some investors embed distressed/turnaround equity as part of their private equity allocation and include distressed debt and private credit as parts of their fixed income allocation.

Venture Capital consists of investments in start-up and early-stage, high-growth private companies, principally in information technology and life sciences. Today venture capital is practiced around the world with the main centers of activity being certain well-established locations in the U.S. like California's San Francisco Bay Area, Silicon Valley, New York City and greater Boston; more recently, venture capital is practiced in China, India, Israel and other parts of Asia and Europe. The venture capitalist usually owns a minority stake in the company, but is actively involved with entrepreneurs over a period of years to develop strategy, recruit management, secure financing and set up customer or other strategic relationships with larger companies. The main investment objective is to earn returns above those generally available in the public securities markets, achieved through long-term capital appreciation. This return pattern can be characterized by "home runs" (large gains) and "strikeouts" (complete losses) for any given company investment, which is why manager selection is critical. Any given venture capital portfolio may have a large number of strikeouts.

Private Equity comprises investments in existing companies, most with positive cash flow or profit. Some private equity managers acquire a majority equity stake or buy the entire company, frequently utilizing financial leverage to do so, via transactions such as leveraged buyouts, management buyouts, recapitalizations, reorganizations, privatizations, restructurings and spin-offs.

Unlike buyout style, private equity managers focusing on "growth equity" will typically concentrate on companies with high growth (with positive cash flow) and may use little to no financial leverage. They will often purchase a significant monetary stake with important governance rights. Returns are often driven by the potential for rapid growth. Buyout private equity managers rely more on the use of financial leverage or multiple expansion. However, the common thread across the most successful private equity managers is active involvement in growing earnings of portfolio companies. In almost all cases, the manager works actively with companies in the portfolio to add value by growing sales, making strategic acquisitions, reducing costs and increasing operating efficiencies. Private equity investors seek to earn returns above those on publicly traded stocks over a long-term investment horizon.

The private equity opportunity set is global, including not only developed markets like the U.S. and Western Europe but also emerging markets and other rapidly developing economies. Investors seek higher returns over longer periods of time than those usually available on international public securities exchanges. In addition, they seek access to growth opportunities in countries whose public markets are often shallow and volatile.

Private equity portfolios should be varied by region and country in addition to the diversifiers identified mentioned previously. While private equity investments made in developed economies outside the U.S. are similar to U.S. standards in both practice and return, those investments made in emerging markets can be more volatile. In addition, when investing outside of one's home country, currency impact must be considered. Most U.S. and Asian funds are dollar denominated, while European funds can be euro or sterling denominated.

Distressed Capital is often considered a subset of private equity and generally involves identifying problem companies or troubled assets which managers believe can be significantly improved by implementing turnaround tactics and/or restructuring to unlock underlying value. These companies or assets exist in varying degrees of distress, may already be in default, and may or may not be under bankruptcy protection. In the case of companies, investors may commit new capital in the form of debt or equity and often try to influence the process by which the issuer restructures its debt, hones its focus or implements a plan to turn around its operations. Some investors will look for "non-control" investments, some of which are asset purchases (e.g., pools of bank loans, structured securities, trade claims, bankruptcy claims, etc.), where they do not seek control to benefit from restructuring or resolution of the distressed nature of the underlying asset, albeit still play an active role in approach to value creation and realization.

The U.S. has the most developed distressed market. The global market (especially in Europe) has become more active in recent years as the amount of leveraged and structured lending increased, capital standards for banks have become more stringent, and insolvency laws have evolved.

Natural Resources can cover a diverse set of investments across oil- and natural gas-related companies and properties, mining and metals companies and assets, energy infrastructure (to include traditional thermal power generation and renewables), as well as agriculture and timber properties and platforms. For international exposures, company investments may be made in local currencies with the fund manager overseeing currency risk at that level. These investments offer the potential for enhanced return, powerful portfolio diversification and a hedge against inflation. Natural resources-related managers may employ a number of investment approaches including private equity (purchasing or creating companies) and operating platforms (directly operating assets). Some investors choose to classify their natural resources investments together with real estate investments, commodities and Treasury Inflation Protected Securities [TIPS] in a "real" assets or "inflation-hedge" category.

Private Equity Real Estate involves the acquisition or development of a real estate property. Real estate investing is expected to offer growth of capital, diversification and some level of inflation protection when compared to traditional asset classes. Private equity real estate is a global asset class and the most common property types are office, industrial, retail, multifamily, hotels, student housing, senior housing, self-storage, medical office buildings, single family residential, manufacturing housing, data centers and undeveloped land for any of the above uses, as well as other niche property types.

Private equity real estate funds generally follow core, value-added, or opportunistic strategies when making investments.

Core is a low-leveraged, low-risk/low-potential return strategy with predictable cash flows. A manager will generally invest in stable, fully leased, typically class A, single or multi-tenant properties within strong, diversified metropolitan areas, often in gateway cities.

Value Added is a medium-to-high-risk/medium-to-high-return strategy. It involves buying under-leased or mispositioned property, improving it in some way, and selling it at an opportune time for gain. Properties are considered value added when they exhibit management or operational problems, require physical improvement, and/or suffer from capital constraints. Value-added strategies typically are leveraged between 40 and 60 percent.

Opportunistic is a higher-risk/higher-return strategy. The properties will require a high degree of enhancement. This strategy may also involve investments in development, raw land, and niche property sectors. Some opportunistic funds also will invest in securitized or non-securitized public or private debt instruments, with the objective of privatizing, repackaging, restructuring and then selling off these interests. Opportunistic strategies can employ varying degrees of leverage levels, typically 60 percent and higher.

Structure

The legal vehicle for investing in private companies is usually a "limited partnership." The general partner (the investment manager) manages the enterprise and the limited partners (the investors) own interests in the partnership, which holds the portfolio companies, analogous to shares that are proportional to their investment.

A typical private capital limited partnership has a 10- to 12-year life. When the partnership is being formed, limited partners agree in advance to commit a defined amount of capital to the partnership. The committed dollars are not invested all at once, but are drawn down, or "called," by the manager over roughly the first half of the partnership's life as the manager discovers, cultivates, negotiates and ultimately invests capital into private companies.

During the second half of the partnership's life, capital is returned to the limited partners in the form of distributions. These most often result from a manager's decision to exit an investment, usually through either an initial public offering (IPO) or by selling the investment to a larger company, often referred to as a "strategic buyer," or another private capital firm, often referred to as a "financial buyer." Distributions to investors can also result from a recapitalization of and subsequent dividend by a portfolio company. Distributions can be in cash or stock, referred to as "in-kind" distributions, reflecting an investor's pro rata share of a particular company's stock.

The commitment stage of a partnership may vary in duration and pace, depending on the availability of attractive investment opportunities. In the same way, the distribution phase may vary according to the viability of the exit markets (for example, the quality of the IPO and mergers and acquisitions markets).

Other Structures

Secondaries Investors may also look to gain exposure to the private equity markets by purchasing existing interests in funds raised during prior vintage years and therefore different investment cycles. This practice is called "secondary investing" and is the way in which investors buy an interest in a previously raised fund. Secondary interests come about when an investor wishes to sell or exit all or a portion of their fund commitment prior to the normal liquidation period of the fund. This practice enables prospective buyers to acquire funds with greater visibility of the underlying portfolio companies that have been purchased to date, sometimes at handsome discounts from their current net asset value (NAV). Secondary interests can also help to moderate the "J-curve" in the early period of the investment cycle, since the underlying assets are typically more mature and closer to realization. Secondaries are a natural complement to a primary investing effort.

Co-investments A co-investment is a direct equity investment in a company by a limited partner alongside a private capital manager (or general partner). Limited partners typically engage in co-investments in situations where they believe they have a preferred relationship with a general partner and access to the general partner's full set of information about the company, its management team and prospects. The risk associated with co-investments is that of greater concentration in one particular company in contrast to a partnership investment where limited partners get broad exposure to multiple portfolio companies. The primary benefits for limited partners include an opportunity to invest more capital with talented managers and, in many cases, to invest pari passu with the general partner often without the cost of paying either management fees or a carried interest charge. Co-investment programs can complement fund investment programs but do require a different set of resources and skills from partnership investing.

Expectations

As in all types of investing, setting realistic long-term return expectations is essential for private capital investors. Based on past experience, here are some guidelines.

Relative and absolute returns A common relative return target for many private equity and venture capital investors is 300 to 400 basis points over the public markets. Such a premium compensates investors for the illiquidity of this asset class. On an absolute return basis, the point-to-point pooled net internal rate of return (IRR) to investors for private equity was 15.5 percent over the last ten years for the period ending September 30, 2020, as provided by Burgiss. This is compared to the pooled upper quartile net IRR over the same period of 23.0 percent while the bottom quartile return was less than one percent, reflecting the disparity of returns within the private equity asset class.

Concentration of returns As shown in Figure 1 below, and Figure 9 on page 16, upper quartile managers have historically provided a meaningful return premium over lower quartile managers. This means that, in contrast to liquid public markets where asset allocation is a stronger determinant of returns than manager selection, in private capital investing it is essential to have access to top-tier managers. Investment in private equity and venture capital managers in the lower quartiles may lead to mediocre returns, or even to losses. In fact, some say that median returns may not be worth the effort or the risk associated with private investing.

Risk of loss In spite of the potential for high returns from private capital investments, venture capital investors in particular should be prepared for partial or total losses on a significant number of the underlying companies in their portfolio. This is because any single start-up or early-stage investment carries a material risk that it may not develop into a sustainable business. Loss ratios in other private capital strategies are considerably lower, primarily because investments are made in more seasoned companies that are generally cash-flow positive and further along in their development.

Outside the U.S., returns from developed economies are anticipated to be similar to those in the U.S., while returns from emerging markets can be more volatile. Risk factors, including the political and economic environment and, in some cases, the relatively nascent infrastructure for private capital investing, need to be considered.

The importance of diversification Attractive private capital results are earned when returns on winners in a diversified portfolio amount to multiples of the amount invested, while losses are limited to the amount invested. For this reason, it is important not only that a manager diversify their investments within a partnership portfolio, but that an investor also diversify their private capital portfolio by type of investment strategy and vintage year.

Figure 1

TEN-YEAR MANAGER RETURNS BY ASSET CLASS

This chart reflects the difference between the upper quartile and lower quartiles or spread for public equities, fixed income, private equity and venture capital managers on a time-weighted basis for the period ended December 31, 2020. This reflects the importance of selecting the best managers when investing in the private capital markets.

Asset class	Universe	Upper Quartile	Median	Lower Quartile	Median to Upper Spread	Upper to Lower Spread	Liquidity Scale
Bonds	Domestic	4.7	4.4	4.2	0.3	0.6	High
	Global	4.3	3.5	2.8	0.7	1.5	
U.S. Stocks	Large Cap	13.4	12.7	11.8	0.7	1.6	
	Small Cap	12.3	11.0	9.9	1.4	2.4	
International Stocks	Global ex-U.S. Large Cap	7.4	6.5	5.5	1.0	1.9	
Private Capital*	U.S. Private Equity	23.0	13.1	3.4	9.9	19.6	
	Venture Capital	22.3	10.1	-2.3	12.2	24.6	Low

Universe Source: (c) Russell Investment Group unless otherwise noted. Data on individual universes available on request. Universes are calculated on the basis of total returns gross of fees and expenses. Past performance is not indicative of future results.

*Source: Burgiss PrivateIQ for Private Capital as of September 30, 2020.

Learning: A Checklist of Basics

☑ **Equity Focus** — Generally, private capital investors focus on equity investments, not debt. Their capital is exposed to all the risks and rewards equity ownership represents.

☑ **Long-term Commitment** —The primary motivating factor for private capital investors is long-term capital gains. Investments are illiquid. Many partnerships have a 10- to 12-year horizon and managers hold portfolio investments for two to seven years before exiting.

☑ **Ability to Add Value** — In sharp contrast to practices in the public markets, investment managers generally hold substantial ownership interests and the best managers add significant value to companies in their portfolios.

☑ **Inefficient Markets** — The markets for private investing are inefficient. Managers have access to information not available to the public. In private markets, there are generally far fewer disclosure regulations than there are with publicly traded securities.

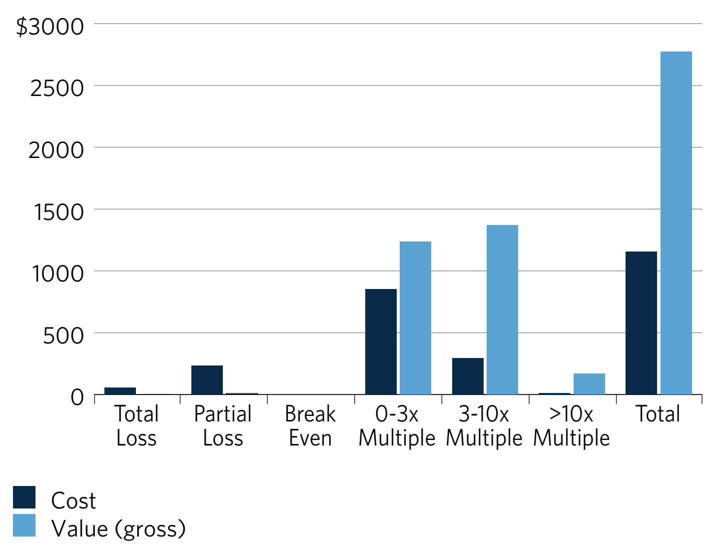
Involve Others in the Process

While you are educating yourself, your trustees or investment committee, it is important to ensure others are also involved in the process. Make certain your committee and fellow trustees are on board. It may also be useful to involve a trustee or other expert who is a knowledgeable advocate of private capital. Your institution's board composition, turnover, recruiting and mentoring all may affect the success of these long-term investments.

Figure 2

DIVERSIFICATION IS A MUST

In private capital investing, a diversified portfolio is essential. This chart sorts 762 portfolio companies from a private equity fund-of-funds program into categories ranging from write-offs to "home runs" (>3x multiple).* Any single private capital investment can be highly risky; however, risk may be significantly mitigated in a well-managed, diversified portfolio.



*Data as of 9/30/20. No assurance can be made that these portfolio company return profiles will be repeatable. Past experience cannot assure future results. Dispersion of portfolio company results may vary in different vintage years and different private capital asset strategies.

Source: Commonfund Capital

Commit

Building a private capital allocation that makes a difference to your portfolio takes time and dedication. The first step is deciding to make a meaningful allocation to private capital. Then, to implement that allocation prudently, you will need to diversify among several types of private capital investments. Finally, the simultaneous inflows and outflows of capital over the private capital investment cycle mean that you will need to overcommit funds within your liquidity budget in order to reach your policy allocation.

Private capital forms an increasingly important part of the asset allocation of most long-term investors, particularly those with larger investment pools. Historically, the correlation between private capital allocations and asset size was due to the greater experience and resources possessed by larger institutions, as well as to the limited availability of good quality private capital managers and programs. Larger institutions have been generally more willing and able to invest in less liquid strategies, which, historically, has contributed to stronger overall returns and lower portfolio risk. This is less true today, as many medium-sized and smaller institutions have embraced private capital as an important source of excess returns and diversification for their portfolios. While a prudently diversified private capital program can be a significant contributor to long-term returns for institutions both small and large, an institution should have investable assets of at least $5 million to $25 million in order to make an allocation to illiquid assets.

The Asset Allocation Decision

Private capital managers draw down commitments on an as-needed basis to fund investments, and the timing of distributions is somewhat uncertain; therefore, it is difficult to manage to a precise asset allocation target. For this reason, successful private capital investors generally set their asset allocations using two broad parameters: they work within a target range and they view the allocation over longer periods of time.

Figure 3

PRIVATE CAPITAL ASSET ALLOCATION

This chart shows how a private capital allocation can be diversified across two primary strategies (private equity and venture capital) and how the allocation can be geographically diversified across developed economies and select emerging markets.

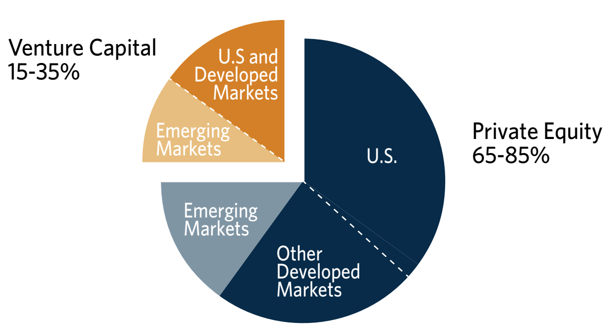
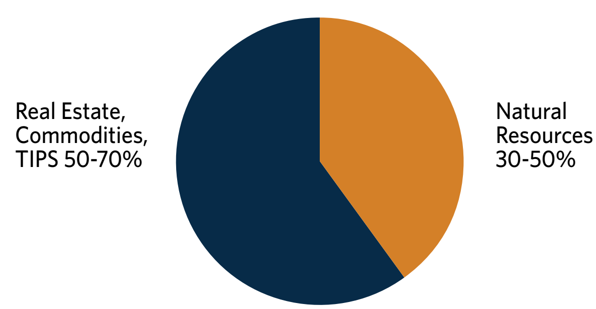


Figure 4

REAL ASSETS ALLOCATION

This chart shows how a 10 to 30 percent real assets allocation can be divided between natural resources and other inflation-hedging assets, such as real estate, commodities and TIPS.



For long-term investors like pension plans, the targeted total return needs to be sufficient to ensure appropriate asset-liability matching over time. For endowment-type pools, investors seek to preserve the purchasing power of investable assets after spending and investment costs. While each plan's specific liquidity needs must be taken into consideration, the focus in constructing the portfolio should be on total long-term risk-adjusted return.

It is important that the private capital allocation be large enough to make a difference in the return of the overall portfolio. Depending on the institution's goals and policies, Commonfund Capital normally recommends an allocation to private capital of at least 5 percent to start; over the longer term, we suggest for some plans an allocation in the 5 to 15 percent range, especially those perpetual pools of capital with longer duration liabilities. (See Figures 3 and 4 on page 7.) We also generally advocate a long-term commitment to real assets such as real estate and natural resources in the 10 to 30 percent range for returns and long-term inflation protection. These allocations should also be diversified across a variety of investment strategies and vintage years.

The Importance of Diversification

It is not sufficient to make a one-time decision to invest in a single private capital fund or manager. Prudent diversification within the private capital portfolio is essential. Because of the long-term nature of the commitments required of private capital investors, even skilled managers may occasionally find themselves in an unfavorable part of the market cycle when the time comes to liquidate a particular fund's investments. For this reason, the private capital portfolio must itself be diversified by strategy and vintage year across each two- to three-year investment cycle.

Over longer-term time horizons, the addition of a private capital allocation can increase a portfolio's overall return by a meaningful amount. Adding private capital may also improve a portfolio's risk characteristics, such as reducing the standard deviation of the entire portfolio and improving value at risk (VaR) and up/ down capture (these terms are defined on page 24).

Balancing Liquidity and Return Potential Through Economic Cycles

Increasingly, long-term pools have policy allocations to illiquid investments like private capital. This means that they also have a policy for more liquid investments to meet spending and liability requirements under normal and stressed scenarios. In order to ensure that the level of overcommitment is consistent with an institution's asset allocation liquidity allotment under normal and stress scenarios, it is important to model expectations for the future using different assumptions to gauge the potential trade-off between being chronically under target (and losing a source of potential return at the expense of increased liquidity) and achieving or, at times possibly exceeding, target allocations (with the greater possibility of getting paid for being illiquid but having less available cash flow at certain points in the economic cycle). This type of analysis gets to the heart of an institution's risk tolerance as compared to the need for and dependence on investment returns and is important to understand in order to establish the proper policy for what has always been an illiquid asset class.

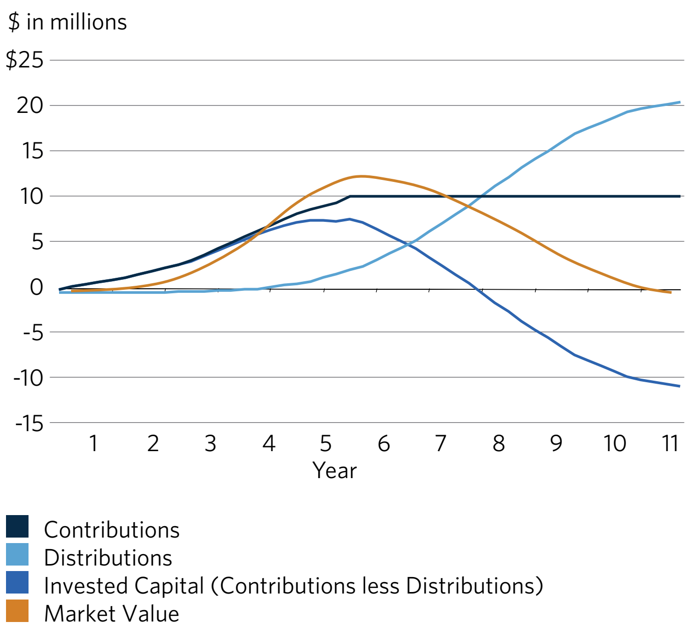
The Need to Overcommit

A final key concept to bear in mind is the need to overcommit. Investors rarely have more than two-thirds of their commitment at work at any one time because managers request, or call, their limited partners' funds over a period of years and, during the same time period, distributions begin. For example, to reach an actual policy allocation of 10 percent, it may be necessary to make commitments closer to 15 percent.

Figure 5

OVERCOMMITMENT: A KEY CONSTRUCT

This chart, citing a $10 million commitment, shows that it is often necessary to overcommit to private capital strategies in order to reach your policy allocation. Note that investors' contributions grow in the early years but, in the later years, distributions surpass contributed capital in successful partnerships.



Notes: For illustrative purposes only. Assuming a fund with an overall 15 percent net IRR and a 2.0x multiple on invested capital.

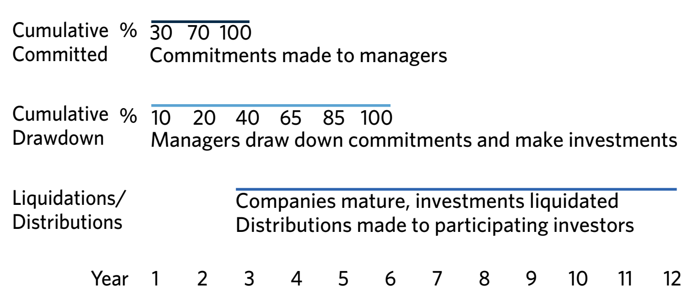
Once an investor has made a commitment to a private capital manager, the manager draws down that commitment only as it finds suitable investments. Such investments are methodically made over a two- to three-year investment cycle. Because of the pace of investing and the fact that these investments are privately negotiated transactions, it often takes multiple years to fully deploy an investor's commitment. (Investors are encouraged to continue to invest the unfunded portion of their commitment in a long-term fashion consistent with their asset allocation.) In addition, at some point in the life of the fund, investors begin to receive distributions on liquidated investments, often before a manager has completely invested the original commitment. At the same time, the investor's overall portfolio may be growing, either through market appreciation and/or additional contributions, further reducing the percentage of capital invested in private markets. Figure 6 below represents a typical implementation schedule for a private capital program.

With publicly traded securities, an investor can fund its asset allocation rapidly. In contrast, with private capital, it can take five years or more to achieve a meaningful or target allocation. When publicly traded securities are sold, the proceeds are quickly reinvested by the manager. When a private capital asset is sold, there is usually no reinvestment by the manager and the proceeds are returned to investors. Therefore, simply to maintain the targeted allocation range, it is necessary for an investor to match the distribution with a new commitment of similar size. From a practical standpoint, overcommitment is the only realistic way to more smoothly create and maintain a long-term policy allocation to private capital.

Figure 6

TYPICAL IMPLEMENTATION SCHEDULE FOR PRIVATE CAPITAL PROGRAMS

This graph shows the typical stages of a fund of funds partnership.



Responsible Investing Considerations

Many investors today, particularly nonprofits, are seeking to align their investment portfolio with the mission of their organization. Commonfund is a signatory to the PRI and as part of our commitment to the principles we have integrated the assessment of ESG (Environmental, Social and Governance) issues into our manager due diligence process. Following are examples of the questions that we ask managers as part of the process. Your organizations may want to consider using these or other questions to integrate ESG into your private capital portfolio.

- Is the firm a signatory to PRI?
- Do they have a dedicated resource within the firm to oversee ESG issues?
- Does the firm have formal policies, procedures and/or memorandums in place to address ESG issues?
- Does the firm have ESG monitoring systems put in place?
- Does the firm offer an education program to members around ESG issues?
- Does the firm report summaries for external use?
- Do they address ESG issues in any fund documentation?
- Are they prohibited from investing in any sectors/geographies due to ESG concerns? If so, which?
- Does the firm have a culture of ESG?
- Does the firm incorporate ESG into their investment/decision making process?
- Are there portfolio company examples of ESG integration/implementation?

Select

Having determined the size of your private capital allocation, you will then want to determine the implementation structure of the portfolio. Private capital investing can take the form of direct investment in private companies, investment in funds organized by private capital managers or investment in a commingled portfolio—fund of multiple private capital managers (such as a fund of funds or a separate account). There are pros and cons to each approach.

Investors need to consider both internal and external factors in deciding how to structure a private capital portfolio. While larger investors, with greater staff capabilities, experience and resources, may be able to identify and manage direct investments, most investors choose to become limited partners in private capital funds— either directly or via a fund of funds or customized account. Finding a structure that matches your organization's skills, resources and risk tolerance is important.

Here are the three alternatives.

1. Direct Investment

In direct investment, no investment manager is involved. Instead, the investor commits capital directly to a privately held company or asset, becoming a full or part owner. Some large institutions invest directly into private equity-backed companies, typically as a co-investor alongside one of their own investment managers, but sometimes as a stand-alone majority or minority investor.

The primary advantage to direct investment is the absence of investment management fees. As a counterweight, however, the investor must bear all the costs of sourcing and evaluating the investment, and of building and managing the portfolio. This includes retaining specialized staff to identify, analyze, manage and dispose of the investments on a timely basis at favorable prices. Each of these steps is time-intensive. Often it is challenging for these investors to gain access to meaningful "deal flow," the term private capital managers use to describe the stream of investment and disposition opportunities from which they choose.

Direct investment can be a risky approach because portfolios are often concentrated; and, achieving meaningful diversification requires considerable capital and management resources. For these reasons, few institutions are able to follow a direct investment strategy.

2. Investment through Direct Relationships with Private Capital Managers

In this structure, investors, as limited partners, commit capital to a fund or limited partnership organized by a private equity or venture capital manager who typically acts as the general partner. As described earlier, the life of the fund is usually 10 to 12 years. Over extended periods of time, a manager generally operates a series of such funds.

The biggest drawback to direct manager relationships is that there are so many managers—well over 7,000 in the global venture capital and private equity sectors alone—that it is difficult for some institutions to identify and obtain access to those with the "hands-on" skills needed to drive their portfolio companies to success. Access to these top-tier managers can be more problematic for small and mid-sized investors and for those who are new to private capital, since, as a practical matter, most established managers are selective, preferring to work with relatively few limited partners able to commit substantial long-term capital. Furthermore, it is not unusual for top-tier managers to have high minimum investment thresholds, meaning that it can take years of relationship building for a smaller investor to obtain access to a desired manager. Another challenge for some modest-sized plans is gaining access to multiple managers to achieve adequate diversification by manager, stage and geography.

In summary, this approach allows investors to build relationships with private capital firms and pay fees only to those managers. While not as resource-intensive as direct investment, this structure still requires extensive time and expertise for manager due diligence, risk management, legal review, manager monitoring, administration, reporting and management of in-kind distributions. If an institution is appropriately staffed, and has direct and meaningful access to a diversified group of top-tier private capital managers, this is a good approach. As responsible stewards of an institution's portfolio, however, comparison of in-house efforts, current or planned, should be weighed against other viable alternatives, including outsourcing, engaging an expert or specialist consulting firm, or using a credible fund of funds or customized separate account managers as partners.

Selecting a Manager

If you are considering investing directly with a private capital manager, it may be useful to review some of Commonfund Capital's own manager selection guidelines:

People How strong is the manager's senior team? These individuals will play critical roles in the underlying portfolio companies in which they invest, so top-notch talent is key. How is the next generation of the firm's leadership developing? Does the firm have a culture of both excellence and ethics—caring not just about results but how results are achieved internally and externally?

Investment strategy fit with your portfolio Does the manager have a differentiated and well-articulated investment strategy? Is the manager a niche player, sector specialist or generalist? Is there a particular focus on industry, stage or deal size? Where does the manager's strategy fit on the risk continuum, and does it make sense for the future? Does the potential return pattern fit with your institution's tolerance for risk?

Prior track record How have previous funds fared? Who is responsible for past performance— current or departed personnel? Verify and analyze the manager's reported results.

Commitment/motivation Do the principals of the management firm have their personal funds at stake in the partnership, thus assuring alignment of interests between the manager and investors? How "hungry" is the manager? How is the general partner's compensation—the asset management fee and share of profits (also referred to as carried interest)—computed and shared? Does the firm's leadership focus more on fee income from larger fund sizes or on carried interest from investment success? What other fees does the manager earn?

Deal sourcing and due diligence capabilities Is the manager able to select the best deals from a high volume of quality opportunities and not overpay, and/or does the manager create their own proprietary deals? Does the manager have the resources to conduct thorough due diligence on potential investments? Are such resources in-house or are they tapped into externally through consultant contracts?

Firm culture What are the history, values, vision and size of the firm? How cohesive is the team? How long have the partners worked together? Do they promote an inclusive environment internally and within their portfolio companies?

Ability to add value to portfolio companies Does the manager have the ability to add value through close working relationships with portfolio company CEOs, senior management and boards of directors? How has the manager worked with portfolio companies to optimize functions such as sales, marketing, finance, distribution, operations, human resources and other key areas?

Exit ability/experience What is the ability of the manager to find strategic and financial buyers for portfolio companies or take advantage of public markets? (This is similar to a public equity manager's "sell discipline.")

Distribution policies What is the general partner's approach to distributions to the limited partners? If they have distributed stock, was it possible to exit at or near the distribution amount?

Reporting What is the overall quality and timeliness of the manager's financial reporting? Is the level of information sharing adequate for due diligence and monitoring? What is the quality of Web information? How easy is it to obtain standard or custom information?

3. Investment in a Commingled Portfolio or Customized Account of Multiple Managers— the "Fund of Funds" or "Manager of Managers" Approach

This is the structure most often used by Commonfund Capital. A manager raises a fund— sometimes called a "fund of funds"— or manages a customized account to invest in partnerships run by several different private capital investment managers. Some investors find one or two fund of funds or customized account managers sufficient for their portfolio; others use this strategy as the core of their private capital program and selectively invest with additional managers on a direct basis around that core.

Figure 7

COMPARING INVESTMENT ALTERNATIVES ON THE BASIS OF BENEFIT TO INVESTORS

From the perspective of the average institutional investor, this table compares three alternative ways of investing in terms of characteristics that may be attributed to each method of investing. Of course, actual experience may differ from these characteristics.

	Direct Investments	Direct Managers	Use of Consultant	Manager of Managers
Internal staff constraints	○	◐	●	●
Internal costs/ resource intensity	○	◐	●	●
Deal flow	○	◐	◐	●
Access to best managers	○	◐	◐	●
Allocation policy/ access fairness	○	●	◐	●
Due diligence	○	◐	●	●
Diversification	○	◐	◐	●
Timeless of reporting	●	◐	◐	◐
Management fees	●	◐	○	○

○ Least Favorable
◐ Generally Positive
● Best

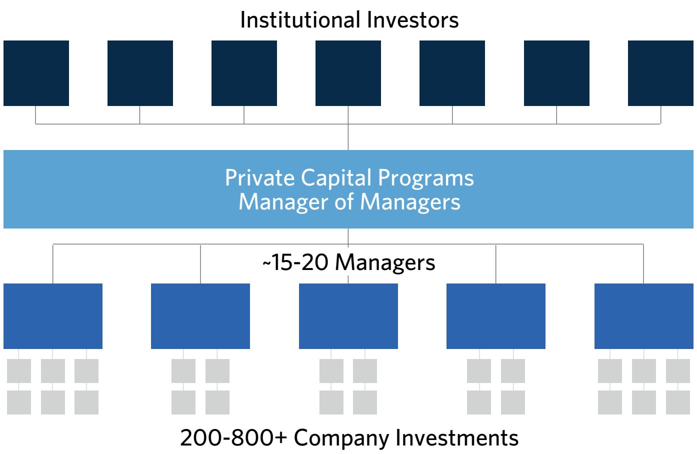
This approach offers several advantages. Access to top-tier managers—the key driver of performance—is the most important advantage. In addition, investors achieve diversification, both across the portfolio and within a particular investment strategy via a single investment. As shown in Figure 8, risk in a fund of funds or customized account is spread among multiple managers and across 200 to 800 (or more) underlying investments, compared with only a few investments in the direct approach or 10 to 40 underlying company investments with a single manager.

One drawback to the fund of funds or customized account approach is that the investor pays a fee to the manager of managers. Fees can vary dramatically, however, so investors should carefully compare manager of managers' fee structures. Another characteristic of this strategy is that reporting can be slower than investing directly with a single manager because results must first be obtained from the underlying managers before being aggregated by the fund of funds manager.

Figure 8

STRUCTURE FOR INVESTING IN FUNDS OF MULTIPLE MANAGERS

A manager of managers raises a fund in a particular strategy, such as venture capital or private equity, and then invests the funds with multiple private capital managers, who, in turn, invest in portfolio companies.



Selecting a Manager of Managers

Many of the characteristics that make a good private capital manager apply to a manager of managers, including depth and experience of staff, ability to conduct initial and ongoing due diligence, experience, culture, quality of reporting and alignment of interests.

Here are some additional factors to consider carefully as you investigate the manager of managers alternative:

People and Culture

Values and guiding principles Does the group do what they say they are going to do? Are their values shared by all, and do they reflect your own values? Do they make decisions with the client's interests in mind?

Skill and experience Managers of managers should be led by seasoned veterans with proven ability and demonstrated good judgment in manager selection and portfolio construction. Also consider analytics, reporting, risk management and the ability to conduct legal reviews. How long has the team been making decisions together? How are decisions made? Does one person or entity have a disproportionately large voice?

Stable organization Review the manager of manager's governance structure and policies. Do they give you confidence that they can attract and retain talented people? Has there been recent turnover in senior leadership? Have changes been abrupt or planned?

Diverse backgrounds Does the team effectively harness the differing perspectives that members bring to the table?

Alignment and structure Has ownership of the management company changed or is it expected to do so? Does the team invest alongside clients to align interest? Does the manager employ leverage at the fund level, which can create an extra source of risk?

Alignment of interests Is the success of the manager of managers' team dependent on the same metrics as your success? Is there a track record of serving client interests? What are the all-in fees? Do you understand the carry, how it is calculated and when it is taken? Does the investment team receive the majority of the carried interest?

Focus on performance What are the firm's long-term audited results? Understand how performance is calculated and be certain it is consistent. Comparisons should be on an equal footing, particularly when comparing to other options. What benchmarks are used? Are all fees deducted to arrive at a true net-to-investor return? What are the realized distributions of each fund? How much cash has been returned to investors relative to capital called?

Strategy and Portfolio Construction

Access to the best managers is the single most important determinant of performance in private capital investing. Is this fund of funds able to identify and obtain access to the best managers consistently over time? Is there always a "seat at the table" for this manager of managers, and are they able to make commitments of a meaningful size or is such allocation modest?

Rigorous manager research Prior to hiring, does the fund of funds track prospective managers over a period of years to gauge their performance through time and various economic and market cycles? Does it deconstruct performance to understand how a manager produces results? Does the manager of managers have an established, documented and proven system of finding, evaluating and investing with excellent managers? Have they been able to spot newer and emerging managers early?

Strong relationships with leading managers Have you made reference calls to the fund of funds' underlying managers to inquire about the quality and consistency of their work and the managers' overall satisfaction with the relationship? Have you gone beyond calls to managers on the "reference list" provided to you by the firm?

Diversification/continuity/flexibility How consistently and thoughtfully are new funds launched by this manager, allowing you to achieve and maintain your private capital allocation? Is the product line broad enough to allow you to diversify your private capital portfolio? Does the manager of managers allow you to set your own allocation to each private capital strategy (e.g., venture capital, private equity and natural resources)? Does the manager offer a commingled vehicle for investors who want help with the strategic allocation decision? Are the minimum/maximum permitted investments in line with your needs? Does the manager size its funds according to market demand or are funds sized and capped in a manner that has the potential to generate attractive returns?

Fees Fees and expenses vary widely. Review the partnership terms carefully. Typically, fees for funds of funds are based on an annual management fee and carried interest, which is an interest in the net profits of the fund or account. Are the fees low enough to enable investors to obtain access to high-quality managers on a cost-effective basis? What is the value proposition?

Concentrated portfolios Does the portfolio have so many private capital managers that you will likely wind up with median returns? Or has the manager of managers struck the right balance of diversification and concentration?

Tailored to long-term pools of capital Is the manager of managers sensitive to your organization's requirements, vision and mission? Does the manager understand the operating constraints you face and the role of private capital in your larger portfolio?

Process and Execution

Qualitative and quantitative due diligence Do you understand how the manager of managers does its due diligence on underlying managers? Do you have insights into the depth and scope of the manager's due diligence?

Consistently high standards across all investment areas Does the manager of managers establish one set of standards for private equity investing, but another, for instance, for natural resources or venture capital? Or are measurements uniformly high across all investment areas?

Trusted adviser to managers Is the manager of managers invited to join limited partner advisory boards, and are senior staff members sought out by private capital investment managers for advice and counsel on strategic questions? Is the fund of funds close enough to managers to obtain material information, and yet detached enough to make objective decisions?

Hands-on monitoring of portfolios What is done on your behalf after the manager of managers makes a commitment? Are there regular and systematic quarterly and annual reports on how the fund is doing?

Communication and ongoing education Does the manager of managers consider it important to communicate openly and candidly? Is information made available as quickly as possible? Are reports presented in a usable format, particularly for presentation to your institution's investment committee? Is information easily accessible online? Does the manager of managers consider client education a priority? Will it present periodic performance updates to staff and trustees?

Committed to continuous learning and improvement Does the manager of managers' organization reflect a culture that encourages learning, and does management believe in the principle of continuous improvement?

Structure and Systems

Independent decision-making Are the people you are hiring the final decision-makers at the manager of managers? Or are they encumbered or influenced by bureaucracy or organizational inefficiencies?

Comprehensive risk management Does the manager of managers' organization have an active risk management function, and is risk management an integral part of its portfolio construction and manager monitoring processes? Is there a compliance team, and are there independent external audits? Is the manager of managers registered, and what is their history of regulatory findings during periodic audits?

Dedicated accounting team Does the manager of managers fully understand all relevant valuation and accounting principles and rulings associated with private capital? Have they managed in-kind distributions successfully? Does the firm's reporting meet your own reporting requirements?

Supporting resources Beyond private capital investment decisions, does the manager of managers' organization have specialists focused on legal matters, accounting and risk management as well as service professionals who are readily accessible to limited partners?

Legal review A key part of your due diligence is legal review, beginning with partnership agreements. But there are also critical questions to ask, such as: Is there any material litigation against the manager of managers? Is there a

Selecting Managers: A Checklist of Basics

Unless you opt for a program of direct investment in which you select, manage and dispose of the assets entirely on your own, you will be investing through an intermediary.

How do you judge a prospective investment partner? Here are some pointers to follow:

- ☑ **Management Team** Look at experience, depth, track record, stability and culture. Is the chemistry right for you?
- ☑ **Value Added** An essential tenet of private capital investing is that the underlying investment managers work with portfolio companies to add value; similarly, manager of managers entities add value in portfolio construction, research, due diligence, monitoring and reporting.
- ☑ **Analytical Capability** Calculating and evaluating returns on private capital investments is different than for publicly traded securities. Be certain you understand this difference (see "Measuring Return" on page 20) and that you are confident of the manager's ability to satisfy your information needs.
- ☑ **Terms and Conditions** Fees and manager compensation arrangements, contract terms and limited partners' rights vary widely. Make it a point to be informed about and understand accepted industry practices so that you get a fair deal. Assure yourself that there is alignment of interests with the manager— a key to successful investment performance. Do the principals have a vested interest in long-term investment results? Do they invest meaningful amounts of their personal money in their own funds? Do they care more about investment results or fee income?

robust general partner clawback provision? (A clawback provision provides for the general partners to return to the limited partners any compensation beyond that specified in the partnership agreement.) Does the legal agreement reflect the understanding from your meetings with the manager?

Build

A strong private capital program requires consistent, diversified investing over time. It is also necessary to have— or obtain externally— resources for research and due diligence before you invest; ongoing monitoring afterward; and useful, reliable internal reporting to ensure appropriate controls.

Focus on Portfolio Construction

Because the top-tier private capital managers generate a disproportionately large share of returns within the industry, it is essential to have access to those managers. "Average" returns in private capital investing are likely to be mediocre or, worse, could result in losses. For this reason, the most critical factor in private capital portfolio construction is manager selection. As shown in Figure 9, upper quartile private capital managers have demonstrated an ability to deliver 11 to 16 percentage points in added return annually compared with lower quartile managers.

Because it delivers so many benefits, diversification should also be a principal goal for your private capital portfolio. Investors may obtain meaningful diversification in a number of ways. Here are several ways that Commonfund Capital diversifies its portfolios.

By investment strategy Create a balance of private equity, venture capital, natural resources and other private programs. And, embedded in these strategies, allocate to secondary interests, co-investments, distressed/turnaround opportunities and select emerging markets exposure.

By manager Invest with several managers in each asset strategy over a two- to three-year cycle to capture specific expertise and hedge against the possibility of organizational risks such as the loss of key personnel.

By style and strategy Identify managers whose styles and strategies are complementary within a portfolio.

By stage of development Invest with managers who work with companies at different stages in the development cycle— from start-up to restructuring.

By vintage year Find managers who raise funds in different vintage years, allowing you to dollar-cost average and even out the vagaries of economic and capital market cycles.

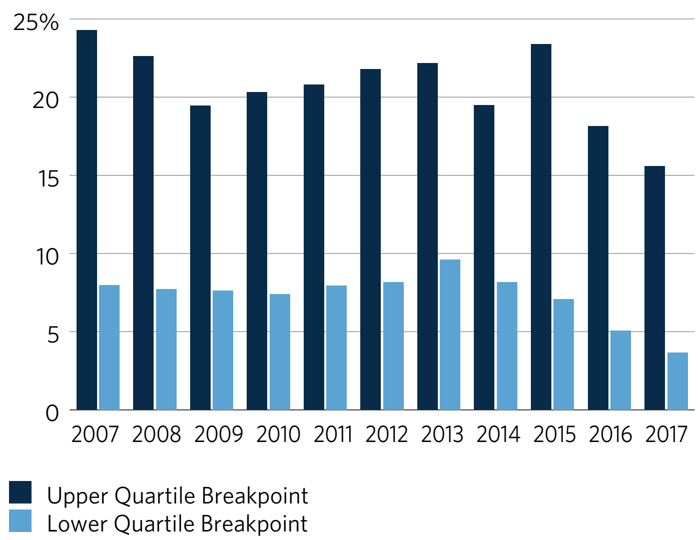
By industry Choose managers who participate in a range of industries as well as focused specialists who concentrate in one or two.

By geography Offset country- or region-specific risks and participate in strong economies both in developed and appropriate emerging markets by creating a portfolio that has broad global exposure.

Figure 9

RIGOROUS MANAGER SELECTION IS A KEY TO SUCCESS

This graph traces the difference in return between upper and lower quartile breakpoints for vintage year private capital funds over the period 2007 to 2017. The fact that the difference is so large stresses the importance of investing with upper quartile managers. For example, in 2009, the spread between upper quartile and lower quartile was 16.3 percent, a significant difference in the pooled returns.



Source: Burgiss. Data as of September 30, 2020.

Invest Consistently

Commonfund Capital believes strongly in the practice of continual commitment over time to the various private capital strategies. This process allows investors to incorporate the time-tested policy of dollar-cost averaging into their portfolios. It also recognizes the fact that returns can vary significantly by vintage year. A number of external factors make some vintage years better than others, including the state of the economy, the public and private market environment, and conditions within a particular industry.

Market timing is discouraged in the public securities markets, and is even less effective in the private capital markets. Investors who try to time the private capital market may justify their approach by saying that too much money is flowing into a particular market, that deal valuations are too high or that the opportunity set is not especially attractive. Any or all of these factors can be cited to justify withholding funds from private capital investing and waiting for better conditions.

There are a number of problems with this thinking, however. One main difficulty is that it is impossible to predict today what the investment and exit environments will be like over the 10- to 12-year life cycle of a typical private capital fund. Experienced private capital managers point out that debate is inevitable; for example, over the past two decades the high level of capital inflows has generated discussion in all but a few years. In the long run, the best strategy is to invest consistently with managers who have demonstrated an ability to add value over time and through economic cycles.

Characteristics of Good Investment Partners

It is not just investors who are judging managers; the managers, in turn, are looking for investors who exhibit certain traits that make them desirable partners. What are they? Here are a few traits to use in considering your own desirability as a partner.

Patience Is the investor prepared to wait out the inevitable ups and downs of the market?

Commitment Are they able to be consistent and reliable investors over many years?

Long-term perspective Do they possess the long view that goes hand-in-hand with patience and commitment?

Informed Do they understand the private capital asset classes and keep abreast of market conditions?

Willingness to work Are they able to do their homework, to ask the right questions and serve on advisory committees?

Quality people Do they hire qualified, knowledgeable staff, who are likely to stay engaged with their employer, and commit time and energy to the process?

Consistency and depth of relationship Do they see consistent faces over time and have they gotten to know staff at multiple levels over multiple cycles (senior investment leaders, mid-level professionals and accounting staff.)

Perform Legal/Risk Management Review

A private capital relationship is a partnership for the long term. Unlike a manager of public equity or fixed income portfolios, a private capital manager cannot be easily or quickly terminated. Instead, when you become a limited partner in a private capital fund, you commit to a relationship of 10 years or more. For this reason, a competent legal review of the limited partnership agreement governing the relationship with the private capital manager is essential.

The partnership agreement should align the interests of the general partners as closely as possible with those of the limited partners. The economic terms of the contract are important, of course, but other aspects of the agreement, such as the terms that govern the partnership and rights of the limited partners, are crucial as well.

When they conduct their review of the draft legal documents, investors must make certain that there are sufficient controls on the manager's activities.

As part of the decision to hire a manager, we and our legal team at Commonfund Capital review the important legal documents. We take an active role in negotiating the most favorable terms where appropriate. Another important part of our due diligence process is a comprehensive risk management questionnaire that every manager must complete and discuss before we make a commitment. In addition, we perform background checks on senior personnel for new manager relationships. We also carefully review the manager's track record. As part of this effort, we generally contact portfolio company CEOs, banking and investment/consultant community contacts, advisers and other limited partners to solicit their views on a confidential basis.

A Centuries-Old Form of Investing

Private capital partnerships are ideally suited for investors whose time horizon extends over the long term. While private capital investing is sometimes perceived as a fairly recent development, early forms of venture investing can be traced to the 15th century.

In the 19th century, Scottish trusts, such as Ivory and Sime, were putting client capital into start-ups of ranches and railroads. In its modern form, venture capital got started in the U.S. in the late 1940s and early 1950s, principally as an investment vehicle for wealthy families. American Research and Development, founded in 1946, was the first true non-family fund. In the 1951 edition of their seminal work Security Analysis, Graham and Dodd saw private capital as being on the verge of gaining recognition as a distinct professional discipline offering "rewards fully commensurate with its demands and responsibilities."

Measure

Private capital investors use a particular set of quantitative and qualitative measures to assess performance. While the standard benchmarks used for marketable securities are sometimes applied to private investments, they have limited value. And, as in other investment fields, historical results tell only part of the story.

Another dimension that is unique about private capital is the way it is measured. Returns in private capital tend to be cyclical, so any risk/return analysis must include data from long periods of time. For certain types of private investments, notably emerging markets and natural resources, data are more limited and less comparable than for developed economy private capital investments.

J Curve Effect

In a typical private capital partnership, returns are low to negative in the early years and then rise over time as investments mature and are liquidated, following a pattern that is often referred to as a "J curve." This occurs because the manager's investments are generally carried at cost on the books of the partnership for an initial time period and until the value-enhancing efforts have a chance to take hold, thereby justifying a higher value.

In addition, expenses incurred by the partnership are not offset by gains over the first years because investments are younger with less time for value to diverge from initial acquisition cost. This phenomenon often creates losses in the early years of the partnership and contributes to the J curve effect.

Leading private capital managers will write down the value of an investment when a company is having difficulties and, within the context of fair value accounting, write it up if the company is doing well. The J curve effect tends to be more exaggerated in times when the investment pace and early value creation are slow, making the impact of management fees all the more pronounced.

Measuring Risk

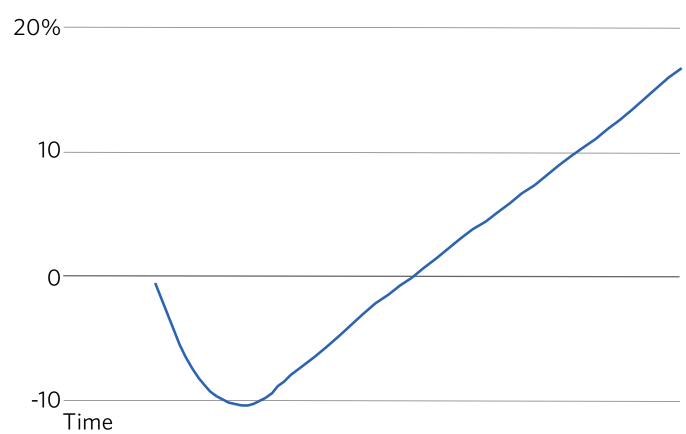
There is no single way to measure risk in private capital. Both quantitative and qualitative factors play a role. Most quantitative analyses show that private capital is not perfectly correlated with other asset strategies and, therefore, enhances diversification in the overall portfolio.

Since many private investments are exited via sales to strategic investors or initial public offerings, however, private capital funds often show robust returns when the public markets are strong. In general, private capital is a subset of equity investing and encompasses similar risks to public equity markets. Private capital managers view their ability to influence a company's management, and thereby the timing of a sale, as one mitigator of public equity market volatility. Other risks vary by investment strategy; for example, technology risk may be a factor in venture capital investing, while in energy investing, two factors are commodity pricing risk and international exchange rate risk.

Figure 10

PRIVATE CAPITAL RETURNS: J CURVE EFFECT

In many private capital partnerships, returns are low to negative in the early years and then rise over time as investments mature and are liquidated, following a pattern that is shaped much like a "J." This occurs because managers' investments are carried at cost until there is a valuation change, and fund expenses produce negative returns until investment gains are recognized.



Hypothetical: For illustrative purposes only.

Measuring Return

There are three basic measurement tools that are used in calculating return in private capital investing.

Internal rate of return (IRR) This is the most frequently used measurement. The CFA Institute requires use of this dollar-weighted method primarily in recognition of the fact that the manager controls the amount and timing of the investment's cash flows.

This methodology differs significantly from the measures applied to public securities managers, who are gauged principally on the basis of time-weighted returns that are not affected by cash flows. Time-weighted returns on a private capital investment can differ significantly from IRR; it is therefore considered misleading to combine the two in a single return presentation.

Multiple of invested capital A second measure, which is used in conjunction with IRR, is the "multiple of invested capital" approach, which compares the appreciated value to the original cost basis of the investment.

Here is an example of how this measure is used. First, assume that an investment of $100,000 returns an IRR of 50 percent in one year. The investor cashes out at $150,000 for a multiple of 1.5. In a second case, another hypothetical $100,000 investment produces an IRR of 25 percent over five years. The investor cashes out at $300,000 for a multiple of 3.0. Although the IRR in the second investment is lower than in the first, the long-term investor might prefer the higher multiple because it produces larger tangible financial gain and is subject to less reinvestment risk.

Comparison to a public index A third measure of return, used as a private capital investment matures, is a comparison of the private capital partnership's return to that of a public market index, such as the S&P 500, the MSCI EAFE or the MSCI World ex-U.S. Most investors seek a return from their private capital investments that represents a premium of 300 basis points above the relevant public market index to compensate themselves for the less liquid nature of private programs and the non-systematic risks involved in investing in private companies. It is important when considering measurement against public indices to match cash flows and pay particular attention to assumptions surrounding how distributions are treated.

Benchmarks

There are few established benchmarks for measuring private capital returns. The most common technique is based on peer group analysis as opposed to a continuous standardized index. For example, a U.S. private equity fund raised during a given year would be compared to all other U.S. private equity funds that were raised during the same period. There are a couple of recognized benchmark purveyors and a few more entities are vying to establish robust private capital benchmarks. Given the variability among providers and overall a high level of dispersion among manager returns, it is important to gauge performance over the long term and with respect to both absolute and relative risk-adjusted returns and expectations.

In addition to benchmarking a single vintage year, investors who take a cyclical approach to committing capital can also benchmark against multiple years. Similarly, there are an increasing number of benchmarks that are geography-specific, for example looking at Europe or Asia.

Policies

Reporting Private capital managers typically report to their investors quarterly. Investors should be aware that in private capital there is a lag in reporting results because it usually takes managers a number of weeks after the end of a quarter to aggregate results of all their portfolio companies. This delay is longer at year-end because underlying portfolio companies and investment managers are generally audited at December 31. For this reason, investors may not receive their annual investment statements until late in the first or early in the second calendar quarter. Tax statements generally follow the completion of the annual audit.

Valuation Due to the illiquid nature of the underlying investments in private capital, valuation practices differ substantially from those in the public securities markets. Standard industry practice is to conform with U.S. GAAP and International Financial Reporting Standards (IFRS) and similar accounting oversight. Fair value techniques include looking at company comparables, discounting cash flows, reports from third-party valuation experts and the investment judgment of the manager.

If a company is publicly traded, it will typically be quoted at its value at the measuring date unless there are compelling reasons not to do so.

Distributions Unlike managers of public securities, private capital managers' distributions to investors are not always made in cash. Instead, managers distribute either cash following liquidation of an investment or the investor's pro rata share of the portfolio company's securities. An important decision for investors is what to do with the distributions they receive from their partnership investments. Management of in-kind distributions can pose unique challenges to many investors, who may not have the resources to manage them for optimal return.

Five Key Steps in the Process

1. Learn

Focus on the unique characteristics of private capital
Include in the education effort all those staff and trustees who take part in your investment decision-making process

2. Commit

Allocate sufficient assets to private capital to make a difference in overall portfolio return and management
Understand the need to potentially over-commit funds in order to reach your target allocation

3. Select

Choose the investment alternative that is right for you
Obtain access to the best managers

4. Build

Diversify your private capital allocation
Invest consistently over time

5. Measure

Develop insights into the measurements that are unique to private capital
Be informed of your investment partners' approaches to issues such as valuation and distributions

Appendices

Glossary of Terms

Advisory Board/Valuation Committee A select group of limited partner representatives who advocate investors' interests with the general partner on certain matters of fund management, often including portfolio fair valuation and conflicts of interest.

Alignment of Interests Investment goals and financial terms that are fair for both the limited partners and the general partners. Managers who invest significant personal funds alongside institutional investors tend to think and act in the best interest of all investors.

Capital Call (Drawdown) When a general partner makes an investment in a portfolio company, it issues a capital call to its investors (limited partners) requesting them to forward their pro rata share of the investment based on their commitment to the fund.

Carried at Cost Managers typically reflect the value of the investments they have made at the cost they paid for them for an initial period of time and until fair value has changed.

Carry (or Carried Interest) The general partner's share of the partnership's profits.

Commitment When a limited partnership is established, each limited partner agrees to invest a certain amount of capital. This amount of money represents the limited partner's capital commitment to the partnership.

Customized Account A fund put together typically for a large, sole limited partner in a manager-of-managers format that provides additional customization to reflect an institution's particular portfolio needs beyond that available in a fund-of- funds format. Investments can include a strategic mix of primaries, secondaries and co-investments.

Deal Flow The number of investment opportunities that a manager reviews over time. Solid deal flow (generally denoting high quality and quantity) is a hallmark of successful managers. Many successful managers can create their own deals, enhancing overall deal flow.

Distribution A distribution occurs when the general partner distributes to the limited partners their pro rata share of cash or securities (also referred to as in-kind distribution) resulting from the realization of an investment and after giving effect to any carry earned by the general partner.

Drawdown/Takedown Schedule The timing plan providing for the actual transfer of investment funds from the limited partner to the general partner. Understanding an approximate timing schedule of takedowns allows investors to plan liquidity and model the expected invested dollars in conjunction with the rest of their portfolio.

Exit Strategy The long-term plan or options a manager has to liquidate an investment and achieve liquidity, usually through a sale to/merger with another company or through an Initial Public Offering (IPO).

Fund of Funds (Manager of Managers) An investment firm that manages private capital investments for multiple limited partners, typically in a commingled fund of funds format, or for individualized, customized accounts. An approach to private capital investing in which a manager invests in partnerships formed by other private capital managers. The benefits of this approach include diversification, access to managers that may be otherwise unavailable and a less intense commitment of staff resources.

General Partner The investment professionals at a private capital firm—and/or a separate legal entity owned by them—are often referred to as the General Partner. In exchange for its investment management service, the General Partner firm earns fees and collects a percentage of the limited partnership's net profits.

Initial Public Offering (IPO) In an IPO, a formerly private company offers stock to the public for the first time.

In-kind Distribution A distribution to limited partners in the form of public shares, as opposed to cash. When distributed, these public shares are typically freely tradable and can be sold for cash.

Internal Rate of Return (IRR) IRR represents an annualized "dollar-weighted" rate of return on an investment. IRR calculation takes into account the cost of the investment, its current value and any intermediate cash inflows and outflows that occur over time. IRR differs from the traditional "time-weighted" (TWR) rate of return used in public markets because IRR takes into account the timing of the flow of funds. In the public markets, the time-weighted rate of return measures the return between two dates and does not factor in an investor's inflows (investments) or outflows (withdrawals).

J Curve During the first few years of a fund, returns are often negative, as expenses of a partnership outweigh portfolio appreciation. This trend often reverses itself as successful investments emerge and are sold or written up. Plotted as a graph of value versus time, this often resembles the letter J, in that returns usually go down before they go up.

Leveraged Buyout (LBO) The purchase of a controlling interest in a company and in which a portion of the purchase price is funded with debt (leverage).

Limited Partner An investor in a limited partnership who has limited liability and is not involved in the day-to-day operations of portfolio companies. Limited partners provide capital for investments but do not participate in management of portfolio companies and cannot lose more than their capital contribution.

Limited Partnership The legal structure most often used in private capital. This vehicle is formed by a general partner who manages the investments of the partnership and limited partners who invest their capital in the partnership.

Limited Partnership Agreement (LPA) The legal document that governs the relationship between the general partner and the limited partners in a fund.

Management Buyout (MBO) The purchase of a controlling interest in a corporation by its management team, usually in conjunction with a private equity firm. In an MBO, typically a portion of the purchase price is funded with debt.

Management Company An entity that is created to manage and is responsible for managing a private capital fund; it may be the same or different entity that is the general partner of the fund. It is generally responsible for the employment of investment professionals as well as rights and responsibilities of the investment manager.

Mezzanine Debt Broadly defined, mezzanine is the level of capital that sits between senior debt and equity. Mezzanine securities typically take the form of unsecured subordinated debt with high current coupon payments and equity participation in the form of warrants or outright share ownership. Mezzanine can also take the form of preferred stock. Although mezzanine is used for recapitalizations and growth financings, the majority of mezzanine debt is issued in conjunction with change of control transactions sponsored by private equity firms. The addition of mezzanine to a leveraged buyout allows the equity sponsor to lever its returns and put fewer equity dollars into a transaction.

Multiple 1. The purchase price of a company divided by a measure of earnings, usually earnings before interest, taxes, depreciation and amortization (EBITDA) or pre-tax income. Managers try to pay the lowest possible multiple for companies and use it as a measure of comparison between investments. 2. Multiple (or multiple on investment or invested capital) can refer to the multiplier indicating how an investment has grown or shrunk in value, as in an investment earned a 3x multiple or $3 for every $1 invested.

Preferred Return Generally speaking, the minimum return that must be generated for investors prior to a general partner receiving carried interest. Preferred returns, when offered, often range from 6 to 8 percent, and seek to ensure that investors receive a minimum return on their investment or that they receive some return first, prior to the manager benefiting from investment gains.

Quartile The segment of a sample representing 25 percent of the group, often used as it relates to performance.

Realization The profit or loss resulting from the sale or other disposal of a portfolio company.

Spin-off 1. The split or separation of a group of employees from a veteran fund manager. Sometimes, spin-offs can be good opportunities for investors if the "new group" has a verifiable track record, and its members have worked together and are hungry to make a name for themselves through superior investment performance. 2. Spin-off can also refer to the split or separation of a division, subsidiary or part of a business from the parent company. Managers frequently target spin-offs for purchase because they often offer significant unrealized potential for value creation.

Standard Deviation A statistical measure of the degree to which an individual value in a probability distribution tends to vary from the mean of the distribution; the larger the standard deviation, the greater the degree of dispersion around the average value.

Up/Down Capture A ratio used to measure how well a portfolio was able to perform in an environment characterized by positive benchmark returns for Up Capture and negative benchmark returns for Down Capture. Larger values for Up Captures are more attractive than lower values. Smaller values for Down Captures are more attractive than larger values.

Value at Risk (VaR) Measures the left tail risk of a distribution, calculated by estimating the probability of portfolio losses based on a confidence level of 95 percent. Larger VaR measures are more attractive than lower VaR measures (i.e., a VaR of -3 percent would be more attractive than a VaR of -10 percent).

Vintage Year 1. The year that a private capital manager forms a fund and/or has a first drawdown. 2. The year that the first investment is made in the fund. Due to the cyclical nature of the industry, managers are compared to other firms of the same vintage year for consistency.

About Commonfund

Commonfund was founded in 1971 as an independent asset management firm with a grant from the Ford Foundation. Together with or through its affiliates, Commonfund today manages customized investment programs for endowments, foundations and public pension funds. Among the pioneers in applying the endowment model of investing to institutional portfolios, we provide extensive investment flexibility using independent investment sub-advisers for discretionary outsourcing engagements, single strategies and multi-asset solutions. Investment programs incorporate active and passive strategies in equities and fixed income, hedge funds, real assets and private capital. All securities are distributed through Commonfund Securities, Inc., a member of FINRA. For additional information about Commonfund, please visit www.commonfund.org.

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