Asset Owners’ Private Investment Dilemma

This whitepaper offers insight aimed at addressing the fundamental issues associated with private market investing and gives asset owners steps to mitigate these challenges.
The Challenge

In this whitepaper, we do not advocate for reduced allocations to alternatives – instead, this paper offers insight aimed at addressing the fundamental issues associated with private market investing. The reality is that asset owners will continue to look to the private markets as an effective way to diversify portfolios and increase returns. The solution is not to suggest this is reckless behavior. It is instead a call for asset owners to institute steps to further mitigate the challenges associated with these investments.

In fact, the DOL recently stated that defined contribution plan sponsors can include private equity options while still complying with ERISA. This gives sponsors confidence that they can integrate certain private equity strategies into defined contribution plans without concern that they are breaching fiduciary duty. This is a big step toward allowing average investors to have similar diversification and return opportunities to that of high net worth (HNW) or institutional investors.

The allowance is a clear sign of both acceptance and necessity that will require innovation rather than suppression. How can pensions expect to earn the superior returns promised otherwise? To add fuel to the fire, there is mounting political pressure along with other influences and incentives for some pensions to maintain or even increase rather than lower expected return levels and associated benchmarks in 2020.

In other words, signs point to private market investing remaining a core component of asset owners’ portfolio allocation strategy. Those that instead elect to stifle allocation to private markets to de-risk portfolios may be left in the dust by their peers over time. Most asset owners are aware of this and understand the nature of the issues with managing private investments comes from a lack of quality in data and analytics. As a result, many are taking measures to upgrade their technology and analyst infrastructure to equip investment teams with better data and tools for meeting high return expectations.

Take City of Fresno, for example. The joint retirement board report authored by their CIO dated May 26, 2020 states “staff does not believe the hodgepodge of proprietary reports and standard data from their custodian is an adequate or optimal solution.” A significant upgrade for portfolio and risk analysis services through Solovis was proposed. Of the six vendor platforms reviewed for replacement, Solovis was identified as “the clear leader and the most accomplished and sophisticated across all investment types.” The report also indicates “certain vendors were weak in key areas that are of primary interest to staff, in particular, underlying portfolio company and/or assets of private market investments.”
Each of the above quotes are very telling. In fact, there are multiple proof points and insights that could be applied to all asset owners engaged in private market investing, including:

1. Analysis of underlying assets of private market investments is of high importance
2. Holistically looking across all investment types, including private investments, is a necessity
3. Many custodian offerings and vendor solutions are sub-optimal in this area

Analysis of Underlying Assets of Private Market Investments

It is no secret that accurate exposure, at all levels, is essential to a manager’s ability to make informed decisions on investment and allocation adjustments. Most plans invest in multiple types of private assets, such as private equity funds, leveraged buy-out funds, credit funds, real estate funds and so forth.

But exposure at the private investment fund level only tells part of the story. For example, the private real estate manager must understand a private real estate fund’s total exposure, as well as the exposure of the underlying investments made by the real estate fund. Exposure by geography for the fund can be different than that of the underlying investment, yet both analytics are highly important to investment managers because different conclusions can be drawn from each.

The flexibility to create sector groups that are unique to individual plan definitions and requirements (as illustrated in Figure 1) is also extremely important.

Figure 1: Solovis Exposure Analysis
By gathering, scrubbing, tagging and maintaining the data properties associated with each underlying holding such as acquisition date, sub industry, region, exposed and total cost basis, exposed and total proceeds, etc. (as shown in Figure 2), numerous analytics can be generated to inform private asset investment decisions. The chart in figure 1 is just one example of the types of calculations that can be performed using these data properties.

For private investments, contrary to market practice, this sophisticated level of data can be automatically obtained via a standardized interface. However, very few data vendors offer this type of information via private analyst services. If focusing on core competencies is preferred over having to independently mine this level of data, outsourced private analysts could act as an extension of the team. An all-in-one solution would maintain the mapping and automated interface that sources the private data, and ensure investment properties and relevant data elements are categorized and stored on the chosen platform in accordance with any unique requirements for how private investment types are handled within your firm. Of course, the depth of what is provided can only be taken so far since access to expansive private information can still prove problematic. For more complicated attributes, asset owners can seek and compile third-party information from multiple sources as needed.

Typically, mappings must be maintained to source data such as daily cash flow transactions, quarterly investor and fund reporting, and portfolio company performance and valuation metrics. The more robust the data collection and aggregation process, the better the resulting analysis. Purchase EBITDA, realized gain or loss, proceeds, etc. on the underlying investments are examples of what can be independently produced or calculated, depending on where and how well the data elements can be sourced.

Taking it one step further, in a future state, analyst services teams can even integrate manager private market deal-level flows into their analysis, using a track record provider such as eVestment TopQ, to record transactions between a manager and their underlying investor activity. Importing cash flows of this nature would provide automated performance insights for managers and help investors understand value drivers.
Holistically Looking Across All Investment Types

What is really referred to here is an Investment Book of Record (IBOR) for asset owners. A general lack of transparency and liquidity in the private sector creates vulnerability to unfavorable economic and business forces, particularly with the unprecedented market volatility we have experienced in 2020. Most private investments only produce valuations quarterly or monthly at best. Some asset classes, such as real estate investments, only produce valuations on an annual basis. While it is important for investment specialists to conduct independent analysis on the investments within their domain of responsibility when and as valuation information is reported, for chief investment officers, looking at private investment data in a silo is not particularly useful.

Private investment data must be normalized into a more public format, setting up defaults for what is then a like-for-like comparison alongside the portfolio’s other public holdings. In the event a current valuation is unavailable, holdings in private equity, hedge funds, natural resources and other non-publicly traded investments can be modeled using sets of public security or index proxies, which should have the flexibility to be updated as desired.

In this manner, more rigorous analysis can be conducted in the context of the entire portfolio with regularity. This is again where only a holistic portfolio management solution and team – one uniquely designed for handling data aggregation and normalization across all asset classes, including private holdings – is positioned to provide timely, accurate information at this level.

It should go without saying there is no perfect solution to either the valuation or risk assessment of illiquid or private investments; but a reasonable, documented approach to more frequent pricing and analysis of these securities is prudent. For example, whether prices are modeled, proxied, actual-traded prices or bids to purchase should be recorded. The chosen method is greatly dependent on the attributes and behavior of the asset class and/or the individual nuances of the specific investment itself.
Why Custodian Offerings and Vendor Solutions are Sub-Optimal

A custodian’s primary responsibility is to produce the accounting book of record (ABOR) and calculate a net asset value (NAV) and thus, calculations will always be based on general ledger accounting results. However, when it comes to private investments, effective “actual point in time” returns and valuations are critical for accurate exposure, performance, and risk analysis. There are innate characteristics of a general ledger approach that make timely, accurate and relevant investment, asset class and market data near impossible for private investment classes.

There are limits imposed by how accounting and custody must handle cash flow and valuation timings – typically settlement/wire/post-date based – that go against the “actual point in time” world of portfolio analysis. Regardless of whether public or private investments are incorporated, portfolio and investment exposure, performance, and risk calculations should not be tied to accounting records – but accounting records are precisely what custodial systems are designed to produce.

Private investments merely add to the complexity, with cash flow nuances like delay days, early wires on capital calls, etc. So, any manual adjustments that must be made to compensate for the differences in cash and investment flows will always be detrimental to accuracy and efficiency. Pushing custodial systems beyond their original framework is not the answer. This gets to the heart of the custodial inadequacies with reporting and standard data that pensions face.

Many legacy vendor solutions are a similar story because using multiple point solutions that specialize in a given asset class has been the chosen path for so many in the industry. Often legacy systems are, in general, single-focused. Meaning, they assume that individual investment attributes, timing and data elements are the same for all asset classes. For example, a public alternative platform may be architected to assume that transactions can only fall at the very beginning or the very end of a month. It may also be architected to assume that asset valuations can only be updated monthly. Obviously, this presents issues for asset owners trying to run all investment types on the same platform. Investments made in private market alternatives such as drawdown funds cannot be handled in this manner. Nor can direct investments.

Within this context, system design decisions - which may have made sense from the standpoint of a single asset class - actually compromise data integrity and reporting outcomes from the perspectives of other asset classes or the portfolio as a whole. A hypothetical pension portfolio is unable to accurately track its public equity, private equity, and real estate investments if it relies upon a performance aggregation system that does not store daily transactional data. It is even less capable of monitoring its unfunded liabilities in this scenario since they generally would not fall within the scope of a public alternatives platform.
Asset owners require multi-asset class coverage alongside individual investment coverage; otherwise, they cannot properly assess how a given investment or asset class is performing relative to others or to the portfolio in its entirety.

If you are considering any solution – custodial or vendor – be sure to request details on how private investments and their underlying positions are handled, as City of Fresno did when they conducted their vendor review and stated certain vendors were weak in this area in their joint board report. Carefully evaluate the way private data is integrated, centralized, and processed. The frequency and level of accuracy of a given technology infrastructure matters greatly. Look for a cash flow processing methodology that can be applied consistently to portfolio management and analysis, allowing for a comprehensive approach across an investment manager’s world, while still giving rightful attention to the individual investment or asset class’ unique characteristics in order to produce the most relevant results.

The more flexible and innovative technology platform described in this paper does exist – and it is quickly becoming the go-to path forward for asset owners and allocators looking for long-term sustainability, agility, and growth.
To learn more about how Solovis’ comprehensive portfolio management, performance measurement, analytics, modeling and reporting tools can help you monitor and manage your institution’s private investments, contact us or explore the Solovis platform:

www.solovis.com/platform