Private Assets Portfolio Construction

When approaching prospective LPs, GPs should ponder the multi-dimensional puzzle these investors are trying to solve. In addition to a strategy's viability and potential to generate outsized returns, many other factors need consideration when constructing a portfolio. During my career, I have come across analytical wizards, snake oil salespeople, not-yet-full-believers of private investing, and know-it-all advisors who all claim to know (intuitively, from historical research, from technological ingenuity, or by sheer sleight of hand) the best way to construct private assets portfolios and broad portfolios in general. I cannot profess to have ever encountered a guaranteed panacea to the conundrums and complexities of portfolio building. However, certain common unwavering themes regularly emerge when discussing portfolio construction approaches within allocator organizations, during reference calls where managers' placements within portfolios are frequently discussed, or during casual analyst conversations about how to define the characteristics of a strategy and how it fits in a portfolio. As mentioned, none of these themes are foolproof by any means, but I have found that sober thinking around these topics can greatly aid in this tricky navigation.

Although each prospective LP is likely to have some nuance in how they position their portfolios, there will be some clustering around broad concepts. It is advisable for GPs to proactively research these broad concepts to streamline interactions with target investors. When GPs can quickly demonstrate how their strategy fits into the portfolio of an LP, discussions can expediently move into the crucial section of the assessment where differentiation at a granular level is more valuable. I highlight some broad themes below:

- **Pesky Risk**: A solid knowledge of risk tolerance is essential to any type of investing, particularly private asset investing. The risk of capital loss, interest rate risk, illiquidity risk, funding risk, operational risk, market risk, etc. all exist in different variations for every investment decision. It is generally well-understood that different segments of private investments are more prone to different types of risk. For example, real assets and venture capital are less prone to interest rate risk than buyout investments. However, venture capital and opportunistic real estate are more prone to the risk of high capital loss than buyouts or core real estate. An LP's sense of what type of risk they are willing to endure (or allocate to) typically depends on the size of the private assets allocation within a portfolio, as well as the composition of the non-private portion. GPs who have taken the time to evaluate the risk nuances of a prospective LP can quickly determine whether or not their strategy matches, and if it does, how to better frame a narrative around complementary factors.

- **Tell Me When**: Concentration is another factor that frequently pops its head during portfolio construction exercises. What percentage of venture, growth, and buyout should you have? What does higher exposure to a particular sub-asset class do to the portfolio? Also, how much concentration do you want in the underlying fund portfolios? There are several ways to dissect the appropriate concentration to entertain, but in my view, the best way to do so is to reverse engineer the answer (or range) from a target return standpoint. As an example, if your private assets portfolio's target return is a 2.2x to 2.5x MOIC (multiple of invested capital), it makes sense to evaluate historical returns (considering volatility and vintage year irregularities) of the available sub-asset classes to determine which portfolio composition is likely to get you to that desired range. There will be multiple ways to solve for the targeted range of returns – this is when the preferences of the investor come into play. Theoretically, to get to the above-stated range, those with a propensity for hard assets may overweight value-add and/or

opportunistic real estate and put lower weights on venture and growth, while those with an affinity for operational improvements in the corporate realm may overweight to small/mid-market buyouts and structure the rest of the portfolio accordingly. Once again, GPs who can discern the concentration attributes/affinities of a prospective LP can paint a clearer picture of how their strategy could be beneficial.

- **Core-Satellite**: The core-satellite frame of thought is an oft-discussed subject during most portfolio construction conversations. The concept has fragments of both “risk” and “concentration” in its basis. The underlying philosophy of a core-satellite private assets approach espouses that the “core” component of the portfolio, which tends to be the larger portion (60%+), is characterized by diversified broad-exposure (by geography, strategy, industry, etc.) and relatively stable investments such as funds of funds, multi-sector larger primary funds, wide-mandate secondary funds, private credit funds, etc. On the other hand, the “satellite“ component tends to be made up of more eccentric exposure to sector-/region-focused strategies, smaller differentiated funds, direct co-investments, emerging managers, GP-led secondary funds, etc. Rationally, the “core” component provides a ballast for the portfolio whilst the “satellite” component allows for tactical and creative risk-taking. By utilizing the core-satellite concept, astute GPs can position their offerings in terms that are relatable to most LPs.

- **To Cash Or Not To Cash**: Although liquidity is an understandable feature for discussion during private assets portfolio construction, I think it tends to garner too much attention. I strongly believe that most of the rewards of private assets investing come from their illiquid nature. Of course, a strategy with early and frequent distributions generates higher IRRs, but the overall MOIC could subsequently suffer. Additionally, early distributions impose a reinvestment burden on both the GP (if recycling is an integral part of its strategy) and the LP who must constantly find new investment options to invest. Illiquidity generally provides sufficient time for fund managers to work their operational improvement magic and helps smooth volatility in the LP’s portfolio. Regardless of what an LP’s liquidity preferences are, a GP knowing what an LP is partial to (in terms of cash flow) can be useful for enticing engagement.

- **Opportunity Knocks Unexpectedly**: “Programmatic versus opportunistic” is a distinction within private investing that is always rich fodder for discussion. A programmatic approach implies a structured (by investment amount, vintage year, strategy, industry, etc.) deployment of investment capital, whilst an opportunistic approach infers a less rigid portfolio structuring attitude that takes advantage of strong investment opportunities as they appear. As would be expected, there are several shades of gray between a programmatic and opportunistic approach. A programmatic-identifying investor, for instance, may also be open to opportunistic investment ideas that offer extremely unique characteristics, and an opportunistic-leaning investor could develop fatigue with a particular sector or go through periods of inflexible allocations. Nonetheless, it is useful for GPs to know whether an LP leans "programmatic" or "opportunistic" to streamline messaging.

- **Honorable mentions**: Other aspects such as an LP’s “existing portfolio”, views on what the LP considers to be “recession-proof” investments, and the LP’s thoughts on “vintage year diversification”, among other things, can dictate its chosen approaches to portfolio construction. An LP’s existing portfolio forms the grounds for decisions to further concentrate in, or diversify away from, certain sectors, strategies, geographies, etc. Although considered a fool’s errand by many, some investors are hell-bent on gaining

exposure to economic sectors considered recession-proof. Historically, investment areas categorized as defensive or recession-proof have included healthcare, consumer staples, utilities, and distressed assets investing. Also, other investment areas seen as exhibiting low correlation to the broader economy appeal to investors seeking to tactically utilize their private assets exposure for stable returns (with the potential for periodic upside) – this includes investments in music/film royalties, litigation finance, artwork, digital assets, life settlements, and digital infrastructure. Lastly, a disciplined vintage year diversification mindset provides LPs a basis for consistent and policy-adhering capital deployment regardless of the short-term portfolio or economic fluctuations. GPs who can identify specific LPs' convictions around building beyond an existing portfolio, the concept of "recession-proof", and vintage year diversification steadfastness, can use this information to their benefit.

I staunchly believe that the potential for outsized returns will always play a major (if not primary) role in an LP's investment decisions, so GPs with strategies that possess convincing evidence of this likelihood will perennially be considered. However, many components, in addition to potential strong performance, come together to form the springboard that LPs use to launch investments. Capital-seeking GPs must get smart about these components.

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