North Sky CAPITAL

First Quarter 2017

Quote of the Quarter:

"We need to find a better way for pension funds to play in the small-to-mid-cap market."

– James McIntire, Washington State Investment Board's ex-treasurer, believes larger pension plans continue to have difficulty investing in the smaller end of private equity, in part because such plans typically have rules limiting the size of their investment to no more than 25% of the total size of a fund.

Asset Allocation vs. Stock Picking

Where Should Board Members Spend Their Time?

Every few years, our market commentary revisits our position in the investment ecosystem. We examine our raison d'être and the value we add to our LPs. While we provide both a series of impact investment funds and a series of traditional private equity funds of funds, it is the latter that we wish to discuss today. This commentary was sparked by a mid-sized institutional investor whose CIO told us he didn't like funds of funds because of the extra layer of fees. Upon hearing this we politely asked the $64,000 question, "do your private equity returns, net of all associated costs (monetary and otherwise), beat ours?"

None of us likes to pay fees if we get nothing in return. However, assuming funds of funds offer nothing in return—or that you get less than you pay for—is a mistake for a surprisingly broad group of investors. To illustrate, we will review the reason investment committees focus their attention on high-level strategic thinking and asset allocation, rather than on picking individual stocks. Similarly, we will make the case many investors should be using a fund of funds, rather than directly selecting individual private equity firms from the thousands of choices available.

I'll Have a Broad Index Fund with a Side of Active Management

If you sit on an investment committee, when is the last time you debated investing in a specific stock out of the thousands of stocks available to purchase worldwide? Never, right? Why is it that your committee has never debated whether to invest directly in either Facebook or Netflix, for example, or in either Amazon or Alibaba? The answer is obvious. To do so would be inefficient, a waste of time and likely result in bickering among committee members over the merits, or lack thereof, of each company. There are over 2,400 stocks traded on ICE/NYSE and almost 2,900 stocks traded on Nasdaq—so about 5,300 stocks from which to choose just on the U.S. exchanges. Each stock has pros and cons and may be subject to cyclicality, seasonality, tax, regulatory and other effects. Each has quantitative and qualitative differences in areas such as backlog, efficiency, pricing power and management's effectiveness. Each is dynamic (ever changing) such that the information you possess about the stock may become quickly out of date.

There is, of course, a better way to allocate your precious capital to a diversified portfolio of stocks: stock indices and mutual funds (and the myriad ETFs that emulate them at low cost). There are a handful of major stock indices such as the S&P 500 or Dow 30 in the USA or the MSCI or FTSE 100 internationally. There are a few hundred choices practically speaking, which is a manageable number and enough options to enable a committee to have a meaningful debate and to make tactical allocation decisions such as the following:

- Should we overweight domestic or international stocks?
- What weighting should we give to large cap vs. small cap stocks? Growth vs. value? Industrials vs. consumer staples vs. healthcare?
- Based upon our short-term cash needs, how much of our portfolio should be truly liquid vs. how much can we commit to longer-term, higher-returning assets?
- We all like clean air and clean water, so should we seek out investments with more sustainable business practices (ESG investments)?

All such tactical decisions are possible and manageable at the board level via mutual funds and stock indices, with appropriate help from your institutional consultant. Your consultant doesn't employ hundreds of research analysts to pour over the thousands of individual stocks; rather your consultant employs enough people to research mutual funds, indices and a handful of active specialist managers and then presents a reasonable number of public equity choices for you to evaluate and select the option best suited to meet your investment objectives.

A well-known paper published in 1986, "Determinants of Portfolio Performance" by Brinson, Hood and Beebower concluded that asset allocation is the primary determinant of a portfolio's return variability, with security selection and market-timing playing only minor roles. In other words, it's important to spend your limited resources (staff time and board input) on the higher level, more impactful things… and to avoid getting too far down in the weeds.

A Fund of Funds is to Private Equity as a Mutual Fund is to Stocks

At yearend, there were 1,829 private equity funds seeking capital from investors (Preqin). That is a large number of choices. In contrast, there were just 146 private equity fund of funds seeking capital—a much more manageable number. In most institutional consulting firms, there are one or two people assigned to source, analyze and recommend individual private equity funds to clients. Based on experience, we estimate that the average tenure of dedicated private equity personnel at such firms is three to four years. Most private equity funds last about 12 years, which means by the time the investment return is known from any given recommendation, the person who recommended that investment may have moved on to job number two or three. High turnover means a lack of (a) quantitative insight, (b) qualitative ability to recognize important trends in the investment or deal sourcing abilities of individual private equity firms and (c) accountability. It can also mean poor returns from an asset class that is supposed to outperform public stocks and bonds by hundreds of basis points annually. Specialization and experience (or the lack thereof) can mean the difference between meeting your investment goals or not.

Alignment of interests also matters here. Will your guide share in your success or failure over the long haul? At North Sky, our philosophy has always been to put our clients' interests first, knowing that if we do well for our clients, we eventually will do well for ourselves. We have Tad Piper to thank for that long-term client-centric outlook, which has been the cornerstone of our firm since inception over 17 years ago. In that vein, we have successfully driven down the annual costs of running our funds (management fees and legal, audit and reporting expenses) and have focused on shared long-term success with our limited partners (significant personal investment, carried interest with a European waterfall and preferred return). If we do our job well, we share in the success. If we don't do our job well, we suffer the economic pain along with our LPs.

Access also matters. Sometimes access arises from being active and in the know. One of the areas in which North Sky shines is in identifying high-potential emerging managers, especially small buyout managers. These are the managers who are the up-and-comers. They have experience and a drive to prove themselves, often after breaking off from another more established firm. They typically are raising their first, second or third fund and are still off the radar of the vast majority of investors. We find them by meeting with as many managers as we can each year, at home and on the road. Our job is to continuously search, analyze and identify high potential private equity managers, including the rising stars you would not otherwise find on your own. It is hard work, but we love it.

We eliminate two other access problems. The first is high minimum investment amounts, which small investors are unable to overcome, while also investing in a big enough number of funds to get sufficient diversification. If your entire private equity allocation is $40 million, and it should be diversified across 10-20 private equity funds and several vintage years, it might take you five years to make those commitments at the rate of $2-4 million per fund. That is tough to do on your own and downright impossible if the minimum investment size for each fund is $5 million. The second access problem is the Woody Allen country club problem—the ones that will have you, you don't want to join; the ones you want to join, won't have you. Not all "good" funds are closed to new investors but many are. Not all funds open to new investors are "good" funds either. A fund of funds is the solution. *There is a lot of value in selecting and accessing high potential managers when the difference between the top quartile and the median return has averaged over 700 basis points from 1986-2013* (Cambridge Associates).

Finally, there is cost. Or better said, the illusion of cost-savings by trying to do it yourself. To meet the standard of fiduciary duty, how many private equity managers within the universe must you meet to prudently pick 3-4 per year? 100? 500? All 1,800? If your investment committee meets at most 12 times a year, how will you find the time to meet these managers, evaluate them and debate which ones to select, even if you were to ignore all the other asset classes? How many full-time investment staff would this require: 5-6 people perhaps costing $150,000 each for salary and benefits? The legal review of the terms of each fund also would cost $5,000 - $20,000 per investment, adding additional expense. Our back of the envelope math, shows substantial savings by using a fund of funds.

Simple Cost Comparison: Do It Yourself vs. Fund of Funds

		Annual	# of Years	Cumulative
Private Equity Allocation	$40,000,000			
DIY Minimum Staff Salary and Benefits Cost		$750,000	10	$7,500,000
DIY Legal Cost		$30,000		$300,000
Total DIY Cost				$7,800,000
Annual FFs Management Fee	0.50%	$200,000	10	$2,000,000
Assumed Investment Multiple	1.7x			
Assumed Gain	$28,000,000			
Carried Interest	5.0%			$1,400,000
Total FFs Cost				$3,400,000
Savings from Fund of Funds*				$4,400,000

*This is nominal. Savings would be higher on a present value basis as carry is paid at the end of the investment (10 years in this case).

There are over 1,800 private equity funds in the market right now, from Apollo Private Equity Fund IX to Z Capital Partners III. Have you seen them all? Most of them? Would you even want to if you had time to do so? Would you want to debate each one at the committee level? Of course not. Prudent investment committees should focus on asset allocation/high level strategy and leave the stock picking and private equity manager selection to the specialists, where it belongs.

If we can help with your private equity investments, whether through a separate account or a comingled fund, please let us know.

Trump, Taxes and Buyouts

There is an ongoing debate regarding the effect proposed tax code changes might have on the private equity industry. Our esteemed Mike Pohlen ran a few scenarios through his LBO model and the results might surprise you.

There is a widely-held belief that eliminating the interest deduction would dramatically lower buyout returns. But if the tax rates also were reduced, many believe the returns would only be reduced by a little bit. It turns out the first assumption is true (returns of course go down a little bit if you eliminate the tax deduction for interest) but if the tax rate also is reduced to 20%, the overall return (at least in our example) would be higher than the status quo ante! See our results below.

Case 1: Current framework where the tax rate is 35% and interest is deductible.
Outcome: 2.46x; 18.1% IRR

Case 2: Tax rate remains at 35% but interest is no longer deductible.
Outcome: 2.28x; 16.3% IRR

Case 3: Tax rate is reduced from 35% to 20% and interest is no longer deductible.
Outcome: 2.53x; 18.8% IRR

Obviously, the analysis must be made on a case-by-case basis. The outcome turns on the relationship of interest expense to tax rates such that scenarios with very high interest expense benefit from today's higher tax rate (and therefore tax deduction) and conversely that scenarios with low interest expense would benefit more from a significant tax rate reduction.

Staffing Updates

We are pleased to announce that Kyle Kroeger has agreed to join North Sky in April as a senior associate. He will be focusing on our clean energy infrastructure business. Kyle comes to the firm with a background in clean energy project finance and investment banking.

Upcoming Events

We are regular speakers and attendees at key industry conferences. We hope to see you at these upcoming events:

Mar. 29-Apr. 1	IBEW Construction & Maintenance Conference, Washington, D.C. www.ibew.org
Apr. 18	Investing for Impact, San Francisco, CA www.investingforimpactevents.com
Apr. 25-26	Impact Capitalism Summit, Chicago, IL www.impact-capitalism.com
May 3-4	FOX Wealth Advisor Forum, Chicago, IL www.familyoffice.com
May 10-12	US SIF Annual Conference, Chicago, IL www.ussif.org

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