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PRIVCAP REPORTS/

In-Depth Analysis From Privcap.com
Q4 2014

Endowments

HOW ENDOWMENTS AND FOUNDATIONS APPROACH PE INVESTING

With expert insights from leaders at:

Princeton University Investment Co.

Tulane University Investment Office

Washington University Investment Management Co.

Ascension Investment Management

Clayton, Dubilier & Rice

Endowed With Wisdom

Endowments, with their ultra-long-term investment horizons, are well suited to investing in long-term value creation projects, whether the underlying assets be private companies, infrastructure assets, or other big, heavy things.

Endowments stand out as being early-and-often investors in private equity, making some of the largest average allocations to the sector. Leading up to 2007, the returns that many of the endowments' portfolios—notably Yale University's—generated were eye-popping. This caused other endowments to allocate heavily to the asset class and pushed others to seek out "endowment-style" investment models. These models most often made heavy commitments to illiquid assets like private equity and timberland. The thinking went, if you want to act like an endowment, load up on PE.

But endowments, particularly those at schools, are for the benefit of the living and need to pay out capital to their beneficiaries. Schools need cash, as do grant-making organizations. In the most recent financial downturn, some PE-heavy endowments found it hard to find the cash to keep their programs going and, unable or unwilling to go through the laborious process of chipping away at their illiquid portfolios, they sold stocks at the worst possible time. The long-term and illiquid characteristics of private equity, which had been so appealing, suddenly seemed risky.

As markets have recovered, private equity has emerged as the least bad asset class, and endowments have emphatically stayed true to it. Inside this report you'll find three in-depth articles featuring Thomas Franco of Clayton, Dubilier & Rice and Daniel Feder of Washington University Investment Management Co, in conversation with three influential investors who are taking sophisticated approaches to manager selection, risk management, and investment diversity.

If you want to think like an endowment investment manager, a good first step is to carefully consider the thought leadership featured in this report and its related videos.

Enjoy the report,

David Snow
CEO & Co-founder
Privcap
@SnowsNotes

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Princeton's Approach to Endowment Investing

Princeton University Investment Co.'s **Jim Millar** discusses how he manages the private equity and venture capital investments of the school's $21B endowment

Jim Millar

Managing Director
Princeton University Investment Co.

Bio

Millar joined PRINCO in 2008 to lead its private equity investments. He previously spent 25 years in the venture capital sector, investing in early-stage technology companies. Millar formerly served as chairman and president of the Mid-Atlantic Capital Alliance and is a former member of the National Association of Small Business Investment Companies board of governors. He began his career as a systems engineer. Millar holds a degree from Yale University and an MBA from the Wharton School of the University of Pennsylvania.

Thomas Franco

Partner
Clayton, Dubilier & Rice

Bio

Franco is responsible for managing several of CD&R's key external relationships, including limited partners. He also manages fundraising and is involved in related capital access activities. He previously served as a senior adviser to CD&R, was the founder, CEO, and chairman of Broadgate Consultants, Inc., launched PEI Media, was a securities lawyer at Finley Kumble, and worked at Georgeson & Co. Franco sits on the board of Privcap Media. He received degrees from Fordham University and the University of Notre Dame.

Daniel Feder

Managing Director
Washington University
Investment Management Co.

Bio

Feder is managing director of private markets at Washington University. Previously he was a senior investment manager in endowment services at TIAA-CREF, managing director of private markets for the Sequoia Capital Heritage Fund, and managing director of PE and VC with the investment office for Princeton University's endowment. He received degrees from the University of Massachusetts, Boston University, and Trinity College.

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Daniel Feder, Washington University: Could you talk us through Princeton's endowment and give us an overview of its private equity venture programs?

Jim Millar, Princeton: Princeton has a $21B endowment, and its function is to provide operating resources for the university over the long term. Today it provides about 50 percent of the annual operating [budget], and it's [funding] important things like financial aid and research. So at the investment office, the goal is to invest [the endowment] so we can spend roughly 5 percent of it a year on the operating income and make enough on top of that to keep up with inflation. The principle is that 20 years from now, the endowment is worth the equivalent of what $21B can buy [now], with the same purchasing power.

Feder: How important is having a concentrated roster of managers in doing that?

Millar: It's important for a couple reasons. Our goal for the private equity portfolio within Princeton is to have top-quartile returns. When we look at it from a return point of view, that's difficult to do without a concentrated roster. You have to make some big bets and concentrated bets. If your bets go wrong, they're going to pull you down in a big way.

But having large numbers [of managers], the diversity of that is illusionary, in a way. Taking concentrated bets is a way that we can increase the return. But it also enables us to be a better partner. We can spend more time with a GP.

It's difficult to do that if you have too many partnership relationships. Relative to the endowment world, we have a large staff of 20 investment professionals, six to seven of which spend some time in private equity.

Feder: What are the advantages of being a large endowment in getting to the opportunities that can elevate the performance of the overall portfolio?

Millar: We like to refer to ourselves as the Goldilocks size: not too big, not too small. We target a quarter of the endowment as private equity—so, a sizable chunk. This is a $5B to $6B portfolio, but it's not so large that we need to deploy hundreds of millions of dollars into each fund. So how do we utilize that? One [way] is the staffing. We do not tend to use outside resources to help us with diligence or research. Two, about a third of the endowment and a third of the PE portfolio is outside of North America. We don't have offices in Europe or in Asia, which means we go there.

Tom Franco, CD&R: You make a compelling case for the competitive advantages of a large endowment platform. So talk about the smaller endowments and how they ought to think about the asset class. How should they play?

Millar: [Private equity is] an important asset class to have in your endowment just because of the return potential it brings. My recommendation would be that [smaller endowments] focus on the managers and try to have a concentrated portfolio. One of the challenges you have as a smaller endowment [is that] if you're going to allocate 5, 10, or 15 percent to private equity, it's still not a big number. A lot of people look at it and say, "I need to have it spread across many managers so it's diverse enough." My recommendation would be to pick out three to five buyout managers and allocate the limited resource into those. The risk is, if you're wrong on one of the three, it's really going to hurt your returns. But that actually forces a better decision.

Feder: One of the things a major university or a great college has going for it as an endowment investor is the networks that it has around the world. I'd be interested to hear how you go about harnessing information and those networks to advance the investment program.

Millar: It is a huge advantage that we do have a worldwide network of our managers. The majority of the board of directors of the Princeton University Investment Company is alumni. And then we have the trustees. Those are usually our first go-to.

Let's say we're looking at something in Sweden. We try to find somebody who has experience, who knows the group or knows somebody who does. And usually there's a 100 percent hit rate. The question is, how valuable is that information? A bigger source of the network is the existing managers we have. We have a very close working relationship with them.

"We like to refer to ourselves as the Goldilocks size: not too big, not too small. We target a quarter of the endowment as private equity—so, a sizable chunk. This is a $5B to $6B portfolio, but it's not so large that we need to deploy hundreds of millions of dollars into each fund."

—Jim Millar, Princeton

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Jim Millar, Princeton; Thomas Franco, CD&R; Daniel Feder, Washington University

> **"Our goal for the private equity portfolio within Princeton is to have top-quartile returns. When we look at it from a return point of view, that's difficult to do without a concentrated roster."**
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> —Jim Millar, Princeton

Feder: Are you able to use those networks across asset classes? Meaning, are you able to use those on-the-ground relationships to diligence or source ideas?

Millar: Absolutely. The way we manage the Princeton endowment is there aren't really silos. I spend the majority of my time on PE, because I head the asset group. But I'm also involved in all the other asset classes. We have two general meetings per week. One is for what we call the non-marketables, which is PE and real assets, primarily. And then we have the marketables.

All the managing directors are [at these meetings], so that we know what's going on in the other areas. When we've looked at new PE managers, particularly overseas, some of our non-PE managers are our best sources of information. Because even in a place like China, the investment network is relatively small compared to the U.S. And that [network is] extremely valuable to us. ■

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Ascension's Long-Term Approach to PE

Ascension Investment Management's **Dale Hunt** discusses her firm's approach to private equity, including strategy, deal sourcing, due diligence, and risk mitigation

Dale Hunt
Managing Director
Ascension Investment Management

Bio

Hunt is responsible for Ascension's private and public equity investments and real assets portfolio. Before joining Ascension in 2010, Hunt spent seven years as the CIO at the West Virginia University Foundation. Prior to that, she was an investment banker at Prudential Securities, S.G. Warburg & Co., NatWest, and ABN AMRO. Hunt has a degree from Boston College and an MBA from Pace University.

Daniel Feder, Washington University: Dale, start by telling us a little bit about Ascension.

Hunt: Ascension Investment Management is a wholly owned subsidiary of Ascension, which owns the largest Catholic not-for-profit healthcare system in the United States. So Ascension Investment Management was formed two years ago; we're an SEC-registered investment adviser. We manage money on behalf of our parent company, as well as other like-minded clients.

Thomas Franco, CD&R: What should investors be thinking about as they plan their programs for the next, say, two to three years?

Hunt: It's a good question. I do take a very long-term view to private equity, so there's always the immediate situation and crisis or trend, and then we seem to get beyond it and go back [to normal]. But today the thing that surprises me is how quickly we've forgotten the [financial] crisis. We went through the crisis, and leverage was going to go away, and multiples were down. Now it seems like we're back where we were just a few years ago.

We are being very careful about using leverage and about being anxious to put too much capital to work, [which] is dangerous.

Franco: How much is too much leverage?

Hunt: It depends on the strategy. We tend to focus a little bit on growth capital, and we tend to focus on more niche players. We're probably seeing less leverage that is being used generically, according to the [market] surveys.

Feder: It would be great to hear about how you source investment ideas and where you get your ideas. How do you access managers, and what's the process for selection?

Hunt: It's all internal. Because we have been doing this for a number of years, we get a lot of inbound calls, as you might imagine, from placement agents and the like. We also still use our network of endowments and foundations, which we're very close to.

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Dale Hunt, Ascension; Thomas Franco, CD&R; Daniel Feder, Washington University

"The thing that surprises me is how quickly we've forgotten the [financial] crisis. We went through the crisis, and leverage was going to go away, and multiples were down. Now it seems like we're back where we were just a few years ago."

—Dale Hunt, Ascension

Feder: As you look at managers and you're assessing them, how do you distinguish one group from another, when their placement memos look similar, their résumés look similar, and their track records are generally presented in ways that look good?

Hunt: When I was at the university [of West Virginia], we were a midsize endowment. It actually made sense, with a small team, to build some of those relationships and do multiple strategies. Now, at AIM with a larger staff, we have the ability to do things differently. So we really focus on sector specialists to the extent we can. We prefer it if somebody comes to us with a real niche specialty. Or it could be the way they structure their transactions. We look for specialists. We do country-specific [investments] or regional; we tend not to do pan-regional funds as much.

Franco: Do you think transparency from the manager to the LP has improved in recent years?

Hunt: It's improved. We're in the space with the small and medium-sized firms, where they tend to have a smaller group of investors who are more actively involved. At that level, I would say our transparency is very good. To the extent that we have any funds that are on the larger size with large LP bases, sometimes the transparency there or the information is still a little bit proscribed.

Feder: Outside of the U.S., how do you go about sourcing investment ideas, doing due diligence on managers, and getting to the point where you're comfortable, especially if you're pursuing strategies that are at the smaller end of the spectrum?

Hunt: It's a long process. For example, in Asia we had looked at Asian managers. We had some Asian exposure, nothing dedicated for a while. And we had looked for the last three or four years. What we try to do is gravitate towards a structure that is interesting.

Obviously the team comes into play. It's a long, iterative process of getting to know the teams, watching the teams, maybe watching a fund, before actually committing to the next fund. But it's a big challenge. ■

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Why Tulane Went Direct

Tulane University's endowment moved from a fund-of-funds platform to direct investing, following a relocation of staff after Hurricane Katrina. Director **Richard Chau** explains how the platform change has affected the way the endowment invests.

Richard Chau
Director
Tulane University

Bio

Chau is director at the Tulane University Investment Office. Previously he was a vice president in Bessemer Trust's Private Equity Funds Group, an investment analyst at the Andrew W. Mellon Foundation, worked in investment banking in the M&A group at Houlihan Lokey, and served as a senior consulting associate at Cambridge Associates. He received degrees from Williams College and Columbia Business School.

Daniel Feder, Washington University: We'd love to hear a little bit about the endowment at Tulane, your office, and the areas where you're focusing your time.

Richard Chau, Tulane: The office is located in Darien, Connecticut, which is a far cry from the university, which is in New Orleans. Prior to Hurricane Katrina we had more of a committee-driven model, relying heavily on outside consultants to really manage the endowment. We had a couple of people on our investment staff in New Orleans, but then when Hurricane Katrina hit, everyone at the university was displaced. So those guys moved up here, and shortly after that the committee decided to change the structure a bit and move towards hiring a real CIO and a full investment staff to do things in-house and move away from the consulting model.

Feder: How large is the Tulane endowment, and what's your basic allocation to private markets?

Chau: Currently the endowment is at $1.2B, with a 30 percent target allocation to private markets. And that's split 20 percent to private equity and 10 percent to private real assets. One of the unique things about our endowment now is that we're underallocated to privates. Within private equity we're sitting at about 14 percent relative to that 20 percent target. And then within real assets it's probably about 7 percent relative to that 10 percent target. Back when we were a smaller endowment with less staff, we mostly accessed private capital through fund-of-funds. That was a nice way to get exposure to the asset classes, but then once we decided to hire our investment staff, we decided to go direct into privates and move away from the fund-of-funds model.

Feder: You're in the midst of transitioning, or reshaping, your portfolio. How have you framed that in terms of managing the existing legacy portfolio and how you move towards the portfolio that you're building directly?

Chau: That's been a challenge. Our direct portfolio is still fairly immature. We started in 2008, but we were still building our own staff, so we weren't making a lot of commitments. In 2009, it was a horrible environment, and not a lot of funds were out raising. So we didn't do too much back then, and then [in] 2010, '11, '12, '13 it started to ramp up to the point where we're now hitting our stride and committing at the appropriate pace for

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Richard Chau, Tulane University; Thomas Franco, CD&R; Daniel Feder, Washington University

"Right now our first goal is to move towards our target. And we're going to do that with the best managers, whether they're in venture growth, equity, or buyouts, energy, or real estate. It's finding the guys who do whatever they do the best and making sure that we start those relationships."

—Richard Chau, Tulane University

where we want to go. But it's been interesting because in some ways the timing has been good to switch to a direct program. We've been able to partner with GPs that, if not for the financial crisis, we may not have been able to gain access to.

Thomas Franco, CD&R: What are you looking for in terms of new opportunities? Are there areas, types of managers, sizes that you think will do better than others?

Chau: Our first goal is to move towards our target. And we're going to do that with the best managers, whether they're in venture growth, equity, or buyouts, energy or real estate. It's finding the guys who do whatever they do the best, and making sure that we start those relationships. Which means that our commitment pace will probably be a bit lumpy. It's going to take some time to find the right managers, gain access and get our full allocation to each of them.

Feder: So how do you go about sourcing the best managers, identifying them, and then getting your allocations?

Chau: We see opportunities come from a lot of different angles, so a good amount of inbound interest, which is great. Managers who know us or somehow find us through different databases, they'll directly email us or call us. Good relationships with placement agents, who know generally what types of funds we're looking for and think they can find good managers.

They'll call us with different opportunities. Keeping relationships with all those placement agents is good, because they scan the market as they're trying to develop their business, and they're seeing a lot of different funds.. Then there's talking to other LPs about what they've been seeing, and hearing generally what they like.

Franco: What are some of the big issues that LPs face when bargaining with GPs?

Chau: One of our issues at the bargaining table is I don't think we've ever been the biggest investor in a fund, or even close to being the biggest investor. We understand that we're not likely to always have the ear of the GP when it comes to term negotiations. But we will always lob in our comments and ask for everything that we think should be moved from market to market. Whether they listen or not is a different story. ■

From the Archives

Compliance & Regulation

The SEC Says You Need ERM

Many PE GPs don't know what "enterprise risk management" is, but the SEC wants them to, as ongoing compliance exams are making clear. A former SEC attorney and experts from New Mountain Capital weigh in.

How to Subtract Value Via Bad Tax Moves

GPs who fail to pay attention to critical tax matters may end up getting a lower price for their portfolio companies at the exit, say two tax experts from McGladrey.

Middle Market

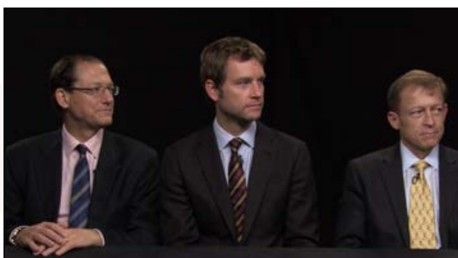
Lending in the Lower-Middle Market

Joe Burkhart of Saratoga Investment Corp. describes how to navigate common caveats when investing in smaller companies, and the implications of weak fundraising in the alternative investments industry.

Creating Value in the Canadian Middle Market

Thecla Sweeney of Birch Hill Equity Partners says Canadian companies face significant challenges that are most pronounced in the middle market. These include weak investments and a dwindling currency advantage.

Emerging Markets



Chinese GPs Eye Credit Strategies

Two credit investors in China and an expert from EY describe why so many Chinese GPs are now looking at expanding into credit strategies.

Growth Market Strategies

Investing in growth markets is now in its third wave, says Abraaj Group's Sarah Alexander. The first two waves taught investors that an on-the-ground presence and a deep dive into economic trends in these markets are important.

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