HARBOURVEST

PRIVATE MARKETS INSIGHTS

DIVERSIFICATION VIA SEPARATELY MANAGED ACCOUNTS

Separately Managed Accounts (SMAs) have rapidly transitioned from a niche investment vehicle to an essential element of institutional investors' portfolio construction toolkit. Through **SMAs**, investors have increased flexibility to construct private markets portfolios that meet their specific goals, needs, and capabilities. Traditional commingled funds remain a highly efficient way to access the strong risk-adjusted returns historically offered by private markets, but SMAs may be attractive to investors looking for:

> Greater control over allocations and fees

> The opportunity to leverage the fund selection expertise of a chosen partner to customize their portfolios

> Investment pacing tailored to meet liquidity needs and allocation targets

> Accounts structured to meet individual financial and legal requirements

> Learning opportunities, either actively through seminars or more passively via close cooperation with the manager's investment team

The flexibility of these separate accounts has led many investors to use them as an effective portfolio completion tool, allowing them to target niche strategies to fill specific gaps in their portfolios and increase diversification. SMAs, however, can have much broader applications when managed by experienced, capable managers. In the right hands, they can effectively offer a turnkey solution for creating a diversified private markets portfolio.

DIVERSIFICATION AND PORTFOLIO CONSTRUCTION

We believe diversification should be a foundational component of private markets portfolio construction, given its potential to significantly improve a portfolio's risk-return profile.

Investors can diversify in many different ways. Each layer of diversification offers unique benefits that help improve the overall risk-return profile of a portfolio (see Appendix for more details). Ultimately there is no one-size-fits-all solution. Rather, portfolios should be diversified in a way that reflects each investor's risk tolerance and return target.

HarbourVest's own detailed statistical analysis has demonstrated that diversifying investments both within and across strategies can help maximize risk-adjusted returns (see below).

HARBOURVEST RESEARCH ON DIVERSIFICATION

For a more detailed, statistical exploration of the importance of diversification, please read our two recent papers: **Rethinking Risk: The Myth of Over-diversification** and **Rethinking Risk: How Diversification Amplifies Selection Skill**

REAL ASSETS AND PRIVATE CREDIT IN SMAs

Two rapidly growing market segments, and potential sources of diversification, are private credit and real assets. Adding either or both to a private markets SMA could be beneficial given their compelling and unique attributes and complementary risk-return profiles.

WHY INCLUDE REAL ASSETS IN MY SMA?

> **Low correlations** – Real assets exhibit low correlation (<60%) with private markets and with broader public markets when investment outcomes are compared over time (rather than using quarterly return correlations).[1] Adding less-correlated assets can improve portfolio risk-return.

> **Inflation linkage** – The linkage of revenue streams to inflation – directly via inflation indices or indirectly through interest rates or commodity prices – means real assets typically outperform traditional debt and equity during inflationary periods.[2]

> **Risk-return enhancement** – Similar median returns to traditional private equity, with room for outperformance via energy and natural resources and greater downside protection from infrastructure.[3]

> **Current income** – Contracted infrastructure assets generate cash income for investors, reducing reliance on capital appreciation, improving interim liquidity, and providing liability/spending matching benefits.

> **Growing opportunity** – Real assets (excluding real estate) AUM was $700 billion in 2018, and is expected to grow to $1.8 trillion by 2023, making it the fastest-growing segment of the alternative investments market.[4]

> **Customization** – High levels of customization available across real assets sub-sectors, risk profiles, and investment strategies (primary, secondary and direct).

WHY INCLUDE PRIVATE CREDIT IN MY SMA?

> **Strong risk-return profile vs public fixed income** – Generally offers higher absolute returns than public market debt, the opportunity for cash income via current interest payments, low correlation to the bond market and differentiation versus traditional debt assets.[5]

> **Capital preservation and downside protection** – Typically offers better downside protection than other debt instruments, with lower default and higher recovery rates.[6] Seniority in the capital structure to publicly-issued debt and common equity helps preserve capital, while terms usually include negotiated contractual covenants that constrain borrowers' financial actions. Floating interest rates help hedge against inflation and rising interest rates.

> **Favorable supply and demand drivers** – Demand for private credit is driven by private equity funds operating in the middle market.[7] The amount of capital raised by funds in this segment is at an all-time high, and allocations to private credit funds are rising in tandem.[8] The US middle market is, in isolation, among the largest economies in the world.[9] On the supply side, many middle-market borrowers cannot access the high-yield bond or syndicated loan markets, while commercial banks abandoned the space due to regulatory pressures following the global financial crisis. Private credit providers have helped fill this void.

> **J-curve mitigation** – Current income generated on a regular basis, offering steadier cash flows than most other private markets strategies. This yield component generates returns much earlier than traditional private equity funds, helping to mitigate the J-curve effect. Further mitigation stems from the typically shorter duration of private credit investments.

> **Differentiated exposure** – Exposure to underlying investments that have little overlap and limited correlation with other private markets strategies. Private credit funds can also be broadly diversified across industry, borrower, and financial sponsor, given smaller individual deal sizes.

To find out more about SMAs, and how HarbourVest can help you achieve your investment goals, please get in touch with your HarbourVest contact or email clientservice@harbourvest.com.

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APPENDIX

THE BUILDING BLOCKS OF A DIVERSIFIED PRIVATE MARKETS PORTFOLIO

INVESTMENT APPROACH > Primary > Secondary > Direct > Asset class-focused	Diversifying beyond primary fund investments provides exposure to other approaches with unique strengths. **Secondary investments** can generate earlier appreciation and help mitigate the J-curve associated with primary investing. **Direct investments** may lower fees and provide alpha via a more concentrated approach. Asset class-focused approaches can provide access to specific sectors with differentiated return characteristics.
VINTAGE YEAR	Diversifying by vintage year provides access to different economic and business environments, reducing both the downside risk from a potentially poor vintage and **the chance of missing upside from a strong one**. It can also improve cash flow consistency.
GEOGRAPHY > US > Europe > Asia > Emerging Markets	Diversifying by geography can potentially **reduce risk and improve returns.** Global markets are not perfectly correlated and may therefore offset weak performance in others. Meanwhile, greater inefficiencies in less developed private markets can lead to more rapid company growth and fund outperformance.
STRATEGY > Venture > Growth Equity > Buyout > Private Credit	Diversifying across strategies hedges against the near-impossibility of picking a top-performing strategy in each fund vintage and accounts for the different performance cycles of the various strategies (see Chart 1).
MANAGER/INDUSTRY	Diversifying across different fund managers helps to reduce idiosyncratic, manager-specific risk. Exposure to different industries may mitigate against shocks to particular sectors of the economy.

> CHART 1: Net IRR by asset class by vintage (%)

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
30.2%	34.2%	33.3%	22.0%	20.3%	11.5%	10.8%	13.9%	17.2%	20.5%	24.0%	24.6%	19.9%	19.3%	20.4%	28.8%
21.9%	32.6%	27.0%	21.6%	18.0%	11.2%	9.1%	11.5%	15.0%	18.3%	19.7%	21.7%	19.0%	17.6%	20.3%	24.9%
17.4%	23.2%	26.4%	20.2%	17.5%	8.8%	8.2%	10.1%	13.2%	15.5%	15.1%	18.8%	16.2%	16.3%	19.2%	19.2%
16.6%	20.2%	20.0%	17.9%	13.0%	8.8%	8.1%	9.8%	12.9%	15.2%	15.0%	18.1%	16.1%	15.9%	17.1%	18.7%
13.9%	20.0%	18.5%	15.9%	12.4%	7.3%	8.0%	9.4%	12.5%	12.1%	14.4%	17.6%	15.3%	14.5%	17.0%	18.5%
13.0%	13.5%	17.8%	14.3%	7.2%	7.2%	6.8%	7.5%	11.3%	10.7%	9.2%	14.8%	15.2%	14.0%	15.7%	18.0%
7.9%	9.9%	5.4%	12.2%	4.7%	7.2%	5.2%	7.4%	11.3%	9.9%	8.6%	8.7%	13.1%	7.3%	12.8%	16.8%
0.2%	3.9%	1.0%	8.8%	4.4%	6.6%	1.2%	6.1%	1.7%	9.0%	-1.4%	8.6%	9.2%	4.4%	11.3%	13.6%

LEGEND
- Asia
- European Buyout
- Global Secondaries
- US Buyout
- US Growth
- US Venture
- US Credit
- US Real Assets

Source: Cambridge Associates net LP pooled returns as of September 30, 2018

[1] Preqin data and De Long (2018) *The Covariance Matrix between Real Assets.* All real assets correlations were <0.6, while private equity, private credit, and private real estate had cross-sectional correlations >0.7

[2] Cohen & Steers. Since 1992, commodities, infrastructure, and natural resources all outperformed real estate, equities, and bonds during periods of higher-than-expected inflation.

[3] Preqin data, as of June 30, 2018. Includes all 8,000+ funds tracked by Preqin since 1981. Infrastructure median net IRR of 10.5%, 25th percentile 6.4%. Energy/natural resources median of 12.1%, 25th percentile 3.6%. Private equity median of 11.9%, 25th percentile 4.4%.

[4] Preqin data.

[5] Cambridge Associates for returns data, as of September 2017. Targeted investment-level gross returns for private credit range from 6-22%. For high-yield bonds 3-7%, investment-grade bonds 2-5%. Aon Monthly Benchmark and Index Report and Cliffwater Direct Lending Index Report for correlations data, as of June 30, 2017. Cliffwater Direct Lending Index correlation coefficients over 10 years: Bloomberg Barclays U.S. Aggregate Bond Index -0.3119, BofA Merrill Lynch Global High Yield Index 0.7081, Credit Suisse Leveraged Loan Index 0.8043, Russell 3000 Index + 300 bps 0.7049, S&P/LSTA Leveraged Loan Index 0.7751.

[6] S&P LCD, CreditPro. Average lagging 12-month default rates by principal amount from 1998 to September 30, 2018: Sponsored loans 3.1%, Non-sponsored 3.5%. Recovery rates by debt asset class from 1989-2016: Middle-market loans (<$200m) 75%, large-cap loans (>$200m) 70%, senior secured bonds 56%, senior unsecured bonds 44%, senior subordinated bonds 30%. Recovery rate is calculated as the value received in settlement, discounted at the effective interest rate on the instrument, as a percentage of the principal default amount.

[7] Middle-market funds defined as having under $2 billion of total commitments. Middle-market companies defined as having an EBITDA of less than $100 million. EBITDA = Earnings before interest, taxes, depreciation, and amortization.

[8] Preqin. Dry powder for investment among US private equity funds operating in the middle market rose to a record-high $339.6 billion as of March 5, 2019.

[9] US Center for the Middle Market, Heritage Foundation, World Bank. US middle market estimated GDP: $4 trillion. Germany GDP $3.7 trillion. Middle market defined as businesses with revenues between $10 million and $1 billion.

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HarbourVest is an independent, global private markets investment specialist with more than 35 years of experience and more than $50 billion in assets under management. The Firm's powerful global platform offers clients investment opportunities through primary fund investments, secondary investments, and direct co-investments in commingled funds or separately managed accounts. HarbourVest has more than 400 employees, including more than 100 investment professionals across Asia, Europe, and the Americas. This global team has committed more than $34 billion to newly-formed funds, completed over $19 billion in secondary purchases, and invested over $8 billion directly in operating companies. Partnering with HarbourVest, clients have access to customized solutions, longstanding relationships, actionable insights, and proven results.