PRIVATE EQUITY PORTFOLIO CONSTRUCTION:
A Four-Step Guide to Getting Started

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CONTENTS
INTRODUCTION ____________________________________________1
WHO IS INVESTING IN PRIVATE EQUITY AND WHY? ____________ 3
STEP 1 DETERMINE YOUR PROGRAM ALLOCATION AND STRATEGY ____________________________________________ 4
STEP 2 BUILD A PORTFOLIO OF INVESTMENT STRATEGIES THAT MATCHES YOUR NEEDS __________________________ 6
STEP 3 CONDUCT A TOP-DOWN, BOTTOM-UP ASSESSMENT ________________________________________________ 8
STEP 4 IMPLEMENT AN ONGOING MONITORING AND OVERSIGHT SYSTEM _________________________________ 10
CASE STUDY EVOLUTION OF A PENSION FUND’S PRIVATE EQUITY ALLOCATION _____________________________ 12
LESSONS LEARNED OVER THREE DECADES OF BUILDING DIVERSIFIED PORTFOLIOS __________________________ 13
INTRODUCTION

The long-term outperformance of private equity relative to public markets is encouraging more new investors to enter the asset class, and prompting many institutional investors to increase their existing allocations. As these investors look to achieve attractive returns and limit their downside risk, a key factor in their success will be their ability to construct portfolios that are aligned with their investment goals and constraints, including their overall risk tolerance.

While this may sound straightforward, it is anything but. Building and maintaining a well-diversified private equity portfolio is a dynamic, complex process that requires highly specialized technical and investment expertise, as well as a strong legal, compliance, operations, and accounting infrastructure. Many investors choose to work with an external investment partner to complement their existing resources, skills, and experience. For those who take this route, it is important to choose wisely as the performance of your portfolio will ultimately be linked to the caliber of the partner you select.

HarbourVest has worked with clients around the world for more than 30 years to help them build and execute their private equity programs – from comprehensive turnkey solutions to flexible, customized accounts. This experience has led us to develop a proven, four-step portfolio construction process that can serve as a blueprint for building a durable portfolio that can help you meet your investment objectives.
WHO IS INVESTING IN PRIVATE EQUITY AND WHY?

Private equity has attracted a broad group of institutional investors whose long-term liabilities match the long-term investment horizon of the asset class. Investors’ capital allocations to private equity, like the broader category of alternative investments, have grown significantly over the past three decades. While family offices – one of the first groups to invest in the asset class – allocate on average over 27% of their assets to private equity, public pensions, the largest provider of capital, allocate nearly 6% on average (see Chart 1).

What’s behind this growth? An increasingly strong appetite for alpha – and the relative outperformance of private equity over the past 10 years – are two of the main catalysts for increased adoption. For pension funds in particular, private equity has demonstrated a meaningful source of gain (in excess of 400 basis points) relative to other strategies (see Chart 2). Capturing alpha for these investors is especially meaningful considering that the actuarial rate of return for pensions is approximately 7.6%.

In addition to alpha generation, private equity can provide built-in diversification benefits given its weaker correlation with public markets, access to more companies and investment strategies, and long-term investment horizon, all of which can provide protection in volatile markets.

As more new investors look to private equity for growth and diversification, it is vital to have a framework in place for constructing a portfolio that is aligned with their unique needs and constraints. This paper outlines four essential steps that can help investors formulate a winning strategy.

Because its investable universe is so much larger than public markets, private equity offers a wider net to capture alpha over the long term.

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1 According to McKinsey, an analysis of more than 130 state retirement funds showed that the median expected future return was 7.65% in 2014. This figure had fallen from 8% in 2012. McKinsey Global Institute, Diminishing Returns: Why Investors Need to Lower Their Expectations, May 2016, p. 30.

2 For example, while there are over 130,000 private companies in the US there are less than 5,700 public companies (CapitalIQ, 2015). The private market opportunity set is also broad: ranging from early stage, growth equity, to distress/mezzanine, mid-market buyout, and the large end of the spectrum. When considering public versus private options in specific regions such as the emerging markets, publicly traded companies typically represent a higher concentration by sector, whereas private investments will cast a much wider net.
IDENTIFY INVESTMENT GOALS AND CONSTRAINTS

The first step in setting up and structuring a private equity portfolio is to take stock of your investment goals and constraints, which will be significantly influenced by your legacy portfolio. The risk sensitivity and maturity status of your existing assets, for example, will be key factors in determining the size of your private equity allocation.

Key considerations include:

> **Cash flow and liquidity needs** – what are your cash flow needs? How long can you wait before having capital returned?

> **Return targets** – how much risk are you willing to assume to achieve potentially higher returns?

> **Comfort with illiquidity risk** – can you accept that your capital will be locked up over an extended period?

> **Complement existing investments** – how do your existing investments compare to the private equity investments you may be considering?

> **Who will make investment decisions?** – do you have the in-house expertise and resources to make what are often more complex investment decisions?

> **Tax issues** – are there important tax implications that will influence how you choose to invest in the asset class?

> **Investment restrictions or constraints** – are there country or state rules that may limit the types of private equity strategies and investments you can access?

ALIGNING PORTFOLIO STRATEGY WITH OBJECTIVES

Once you have identified your goals and constraints, the next step is to align your objectives with an overarching portfolio strategy, which will help define the mix of investment strategies you ultimately choose. Similar to public markets, it is helpful to think about growth, value, and yield as being the underlying attributes within your portfolio.

As a general breakdown, the private equity strategies within these categories include:

> **Growth** – venture capital and growth equity are among the strategies most often associated with investing in rapid-growth companies. Investors can also look to target investments in regional markets with favorable macroeconomic and demographic growth drivers.

> **Value** – US and European buyouts, turnarounds and distressed debt, and special situations represent strategies where GPs are focused on investments that can drive value enhancement through operational, governance, and financial improvements.

> **Yield** – secondaries and private credit are examples of private equity strategies where investors may receive distributions more quickly (e.g., in existing, mature cash-flow generating investments) or receive a fixed interest amount.
ACCESSING PRIVATE EQUITY
Because private equity is a highly specialized asset class, it takes considerable time and resources to develop the expertise, relationships, operations, and infrastructure necessary to successfully access these investments over the long term.

Accordingly, your method of choice will be heavily influenced by the resources and skills you have in place, as well as the extent of your legal, compliance, operations, and accounting infrastructure.

The four primary means of accessing private equity include:

> **In-house** – an in-house program may be particularly attractive for larger, more experienced asset owners who have the resources, expertise, and infrastructure required and who want control and flexibility.

> **Consultant / gatekeeper** – an investor may choose to work with a consultant or gatekeeper to gain discretionary advisory investment services, typically at the front end of the investment decision-making process.

> **Commingled funds** – entering into a limited partnership agreement with a GP offers investors a comprehensive turnkey solution through which the fund manager assumes all of the sourcing, due diligence, investment decision-making, legal, accounting, treasury, tax, and stock distribution responsibilities.

> **Separate accounts / fund-of-one** – investors with significant capital to allocate and highly customized needs – around investment pacing, for example, or a desire to tactically adjust their portfolio to pursue evolving opportunities – may choose to set up a separate account with an asset manager.

As your organization evolves over time and gains resources and expertise, and as your investment needs change, you may need to modify your approach.
Once you have a portfolio strategy and access method in place, you are ready to begin constructing your portfolio by using the core private markets building blocks – primary, secondary, and direct co-investments. Each strategy has different capital deployment rates, forms of portfolio development, and IRR and cash-flow characteristics.

> **Primary investments** – primary investing entails investing in a new fund formed by an experienced or new and emerging manager. Typically, managers make investments during the first few years of a fund’s life, which is generally 10 years. During this stage, the fund’s net cash flows will be negative as it draws down 45% to 50% of the capital and incurs expenses. As value appreciation from early investments and distributions occurs in the middle years of the fund, and as capital calls decrease over time, cash flows will turn positive – thus generating a “J-curve” shape.

> **Secondary investments** – this strategy allows investors to buy into established portfolios of partnerships, companies, and other structured interests. About 80% of a secondary fund’s capital is typically committed to more mature investments during its first four years, which generates capital back to the investor. By buying into these more mature portfolios, often at a discount due to market inefficiencies or the seller’s time constraints, secondaries offer the potential for early appreciation and J-curve mitigation.

> **Direct co-investments** – investors may also invest directly into an operating company alongside, and generally at the invitation of, a lead GP. Typically, an investor in a co-investment fund would have about 80% of its committed capital called within the first four years of the fund’s life. The concentrated nature of this portfolio construction means its cash flows and IRR are more likely to fluctuate from quarter-to-quarter.

Taken together, these strategies should be weighted to meet your goals, and should address any potential limitations you may have. Chart 3 assumes a hypothetical portfolio weighting of 60% in primary investments, 25% in secondaries, and 15% in direct co-investments. The resulting net cash flow curve reflects the time diversification and portfolio development that results from the combined weighting of these three different strategies.
This is intended to be an illustrative example of the pace at which capital may be called by a fund. Investors and prospective investors should bear in mind this is a hypothetical model and, as such, does not reflect actual timing and should not be construed as predicting the future. Hypothetical assumptions are based on experience of prior funds, current market conditions, and current fund expectations. The actual pace and timing of cash flows is likely to be different and will be highly dependent on a fund’s commitment pace, the types of investments made by the fund, the investment pace of the underlying partnerships, and market conditions. Market conditions have a strong impact on investments and realizations and could materially change these projections. These projections should be used solely as a guide and should not be relied upon to manage your investments or make investment decisions. Past performance is not necessarily indicative of future results, and there can be no assurance that future funds will achieve comparable results. Investments in private funds involve significant risks, including loss of the entire investment.
As you build your private markets portfolio, it is important to give careful consideration to the broader, top-down macro risk elements and the bottom-up investment selection risks (see Chart 4). Identifying the macro risks associated with the global economic environment, as well as industry-specific factors, will highlight why it is important to diversify your portfolio across sectors, strategies, vintage years, and regions – and how an appropriately diversified portfolio can help mitigate risk.

In terms of a bottom-up assessment, the two overriding objectives are identifying top-tier managers and investments that can deliver the best risk-adjusted returns across market cycles, and gaining access to funds and other opportunities that may become oversubscribed. Manager selection requires a high degree of due diligence expertise in order to evaluate the sponsor, its strategy and structure, and its ability to leverage a partner’s long-term relationships with proven managers. As well, a proactive approach to monitoring a manager’s investments, leveraging performance information, and continually building relationships with next-generation leaders is essential to long-term success.

Private equity is not an asset class that can be indexed. Investment selection and manager analysis are crucial.
PUTTING THE PIECES TOGETHER
Chart 5 shows a portfolio with a hypothetical core mix of growth, value, and yield-focused investment strategies. In addition to the core program, the portfolio includes a 20% tactical overlay which allows investors to take advantage of market opportunities as they arise.

>CHART 5
HYPOTHETICAL GLOBAL PRIVATE EQUITY PORTFOLIO

For illustrative purposes only. Actual portfolio allocation will be based on available market opportunities during a portfolio’s investment period.
Assembling an appropriately diversified portfolio is just the start in taking a long-term, proactive approach to private equity investing. Equally important is a commitment to active, ongoing monitoring and oversight of the portfolio. This will be critical in helping to keep performance on track and maintaining access to the best GP relationships and secondary and direct co-investment opportunities. It will also help ensure that your diversification objectives stay in alignment with your long-term, strategic plans.

Active management requires sufficient staff and infrastructure resources and expertise in order to accurately monitor performance and keep the portfolio’s many moving parts working together seamlessly. As discussed earlier, the level of your existing private equity capabilities and expertise will generally determine the approach you take to access the asset class, and will be directly linked to your ability to actively monitor and oversee the portfolio.

Monitoring and oversight can be broken into six key areas:

> **GP relationships and secondary and direct co-investment opportunities** – these form the lifeblood of the portfolio, and as such investors need to be actively engaged in maintaining existing relationships, securing access to new ones, and identifying new investment opportunities. This involves a substantial legal component, for example, in terms of reviewing limited partnership agreements and monitoring ongoing amendments. Participation on advisory boards and attendance at annual meetings can also provide deeper insight into a GP’s investments.

> **Cash management** – this treasury function is required to manage capital calls and distributions, as well as to forecast liquidity needs to ensure that there is sufficient cash on hand to meet capital call requirements. If an investor’s treasury resources become over-stretched, particularly as its investment program grows and evolves, it may make economic sense to seek third-party assistance.

> **Valuation** – obtaining and reviewing quarterly valuations of each investment in accordance with fair value standards requires a critical set of accounting capabilities. This function, which may be provided in-house or externally, is necessary for measuring performance and understanding where the sources of value are across your portfolio.

> **Monitoring** – this encompasses monitoring data for each fund investment and the underlying company portfolio. The underlying company operating metrics data is useful in assessing a GP’s performance as it provides insight into how an investment is developing and the factors driving its performance. In addition, the data provides more visibility into how well your portfolio is developing in line with your overall diversification objectives at a company level.

**STEP 4**

**IMPLEMENT AN ONGOING MONITORING AND OVERSIGHT SYSTEM**
> **Reporting** – includes the recording and tracking of risk metrics, as well as portfolio diversification by strategy, geography, stage, industry, and year of underlying company investment. Systematically gathering and presenting key information makes the investment process more transparent. It also facilitates risk monitoring to answer questions regarding the overall “value” of your risk, how much capital is at risk, how you are forecasting liquidity, and what your exposures are to different geographies, industries, and vintage years.

> **Compliance and tax** – this function involves regulatory oversight in the jurisdictions where your investments are based, as well as optimal tax structuring to minimize the risks associated with potential capital leakage. Having a global compliance perspective is particularly important when building a global private equity portfolio. Especially for smaller investors, this extensive compliance coverage may be difficult to achieve without an external manager.

Private equity is an asset class with a lot of moving parts, and it requires a major commitment to operations and infrastructure to be successful.
The global private equity market, investors’ needs and resources, and the portfolio construction process are all dynamic and complex in nature. This is highlighted in the evolutionary path to private equity investing taken by an institutional investor that HarbourVest has partnered with over the long term.

As shown in Chart 6, a pension fund client began its move to private equity in 1984 by first hiring a consultant to help it work through liquidity constraint issues, implement an asset liability study, and determine an optimal target allocation. As the client’s assets under management (AUM) grew and the investor became more knowledgeable about private equity, it made its first commitment to a US private equity fund 15 years later.

Over time, the pension fund’s AUM and the size of its dedicated private equity investment staff grew. Backed by more experience and confidence, the fund began utilizing more sophisticated vehicles to access the asset class. By 2004, the client had gained enough comfort to access market opportunities outside the US by investing in a global fund-of-funds, which by providing diversification helped to minimize investment risk.

Finally, in 2014, with even greater AUM, a considerable increase in its allocation, and more dedicated staff, the pension plan decided to complement its existing approach with a separately managed account aimed at accessing niche markets. By having a flexible plan, actively monitoring and overseeing its portfolio, and working with an experienced investment partner to carry out the strategy, the investor has successfully built a comprehensive private equity program that has provided a 10-year return that exceeded its total plan return by over 500 basis points.

>CHART 6:
SAMPLE ALLOCATION PROFILE ACROSS TIME

<table>
<thead>
<tr>
<th>CLIENT</th>
<th>US public pension fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>AUM</td>
<td>$108 billion</td>
</tr>
<tr>
<td>RESOURCES</td>
<td>Investment staff of 8, supported by operational resources</td>
</tr>
<tr>
<td>OBJECTIVE</td>
<td>Develop strategy to incrementally increase private equity exposure from 2% (2004) to 8% (2014), with 12% overcommit strategy</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>PE Target Allocation</td>
<td>0%</td>
<td>1%</td>
<td>2%</td>
</tr>
<tr>
<td>AUM</td>
<td>$28B</td>
<td>$46B</td>
<td>$80B</td>
</tr>
<tr>
<td>Access Approach</td>
<td>Hired plan consultant</td>
<td>First US fund commitment</td>
<td>Diversified global fund-of-funds</td>
</tr>
<tr>
<td>Dedicated Staff</td>
<td>0</td>
<td>2</td>
<td>4</td>
</tr>
</tbody>
</table>

The client’s 10-year return on PE exceeded its 10-year total plan return by over 500 basis points*

Past performance is no guarantee of future results.
* 10-year return is net of fees and was specific to client’s plan.
LESSONS LEARNED OVER THREE DECADES OF BUILDING DIVERSIFIED PORTFOLIOS

HarbourVest has worked with investors of all types and sizes on their portfolio construction efforts, and these experiences have helped us hone and refine our process. Some of the more common mistakes we see investors make during the initial construction process include:

> **Failing to take a long-term (patient) perspective** – the private equity model of drawing down investor capital, investing, harvesting profits, and redeploying distributions is long term in nature and rewards investors who take a consistent, disciplined approach.

> **Reaching target exposure through an over-commitment strategy** – because an investor’s commitment is drawn down and returned over time, it can be difficult to reach the desired level of exposure. To offset this, investors may want to make a commitment above target or plan to make steady commitments across successive funds.

> **Overlooking J-curve mitigation strategies** – technical knowledge of J-curve mitigation strategies such as secondaries can help counter the negative cash yields generated by other strategies.

> **Trying to time the market** – markets are inherently unpredictable, and timing your investment activity to match the highs and lows is generally not a winning strategy. A safer and more rewarding approach is a disciplined commitment plan that allows for dollar cost averaging into the asset class over time.

> **Investing with too many managers** – in the process of increasing their allocations to private equity, investors may find that they have committed to more managers than they can efficiently monitor. This can lead to an overly diversified portfolio, little investment control, low transparency, and the inability to build productive GP relationships.

> **Being too tactical** – while investors may be tempted to make quick, tactile portfolio tilts to adjust for changing dynamics, there are real limitations given the time it takes to put in place, execute, and build value for any specific private equity strategy.

> **Failing to fully appreciate the negative impact of staff turnover** – investors need to build, develop, and retain private equity teams that have the requisite knowledge and expertise. Maintaining productive working relationships with GPs and identifying opportunities based on long-term pattern recognition becomes challenging when teams lack stability and cohesion.

Avoiding these pitfalls will help you more fully realize the benefits of investing in private equity, namely the potential for higher returns and increased diversification. As we have outlined in this paper, a disciplined, proactive approach and a strong commitment to having the right resources and technical expertise in place are key success factors. Our experience working with all types of clients on portfolio construction strategies over more than 30 years has taught us that there are no shortcuts. You will ultimately get out of your private markets program what you put into it.
HarbourVest is an independent, global private markets investment specialist with more than 30 years of experience and more than $40 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 390 employees, including more than 90 investment professionals across Asia, Europe, and the Americas. This global team has committed more than $31 billion to newly-formed funds, completed over $14 billion in secondary purchases, and invested $5 billion directly in operating companies. Partnering with HarbourVest, clients have access to customized solutions, longstanding relationships, actionable insights, and proven results.

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