How do Veteran Private Equity Professionals Invest Their Personal Wealth

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Partners of distinguished Private Equity (PE) firms are some of the most proficient investors in the world in leading their firms' investment activities. Many are also proficient in managing their substantial wealth outside their firms. However, many are not. The latter group often adopts the so-called 'barbell approach' – with their firm investments on one side and largely Munis and Treasuries on the other. This "safe" end of the barbell offers some risk mitigation in relation to the Equity beta in their firm portfolios, but it also leaves on the table any opportunity to benefit from any excess returns or alpha. This alpha could be sourced from any number of asset classes and investment strategies that have little correlation with their private equity holdings such as Absolute Return, Hedged Equities, Private Real Estate and uncorrelated strategies like investing in Phase III pharmaceutical drug development. Compounded across any decent period of time, this deliberate avoidance of alpha opportunities will meaningfully reduce the PE partner's wealth available for their family, philanthropies and other business investments.

Some investment industry observers refer to Partners Capital as "the money manager to the money managers" given that we advise some of the most sophisticated and demanding asset managers in the world, including senior current and past partners, many of whom we believe to be the most distinguished investment firms in the US, Europe and Asia. Partners Capital is responsible for over $48B[1] in client assets and operates from London, Boston, New York, San Francisco, Paris, Singapore and Hong Kong, with clients across the globe. Of the $48B assets advised, just under half the assets are owned by senior investment industry professionals, mostly Private Equity General Partners ("PE GPs"), with the remainder being the assets of endowments and foundations, where many of the same industry professionals sit on the boards and investment committees. We consider our work for PE GPs as advising their family endowments, with a corresponding long investment time horizon.

Most PE GPs behave in a fairly predictable fashion when it comes to investing their personal capital, even crossing nationalities, age groups, career background and gender. When we focus on those who have been the most financially successful, the similarities grow. Over the past 20 years since we were first established, Partners Capital has become the most dedicated students of this very narrow subset of investors. So what have we learned to help us advise this demanding audience and to help this audience understand themselves?

Partners Capital believe that PE GPs do tend to follow a relatively predictable pattern of behaviour as they come to grips with the scale of their own wealth. But before we discuss the journey they typically travel, we should remind ourselves of who they typically are. Most are extremely well educated, and many have secondary degrees in business or law. Many of them have worked for the top investment banks (Goldman Sachs, Morgan Stanley) or top-tier management consulting firms (Bain & Company, Boston Consulting Group, McKinsey & Company). So this is a highly ambitious, intellectually gifted and analytical group. Few are second generation wealth.

In the early days of Partners Capital, the majority of our clients were first generation GPs who earned the core of their wealth prior to the financial crisis during the economic and financial boom of the 1990s and early 2000's. Today, we advise many of the next (or even next) generation who have

[1] As at 31 December 2021.

accumulated significant cash inflows from huge recent distributions, capped by an astounding 2021 average PE gain of 49% (State Street All PE Index lagged one quarter).

Venture Capitalists are a subset of the universe of the very successful private equity professionals that behaves very differently when it comes to investing their personal capital. For whatever reason, they tend to keep their capital fully invested in the technology arena and struggle to see any better alternative. The PE GP characteristics referenced above apply more to the leveraged buyout (LBO) GP, as many venture capitalists started directly out of business school or came to the venture capital (VC) industry via the tech industry and know little other than the tech industry. Buyout GPs tend to have had broader general business exposure and feel more comfortable diversifying their sources of future wealth away from their direct PE fund exposure. LBO professionals are among the hardest working sectors in business and the professions. PE GPs often pay a very heavy price for their success in terms of family and lifestyle. This context illuminates the motto for how they think about their wealth ---"what is hard won can be easily lost".

What drives the PE GP's personal investment behaviour? There is rarely a successful PE GP who does not think, despite the often-extreme effort put into their careers, that there was a non-trivial element of being in the right place at the right time that explains the magnitude of their wealth. This combination of "I earned it" plus "luck has played a part," may have a major influence on how the average PE GP then goes on to think about their wealth. Unlike billionaire entrepreneurs, oligarchs or multi-generation wealth, PE GPs do not spend a lot. There are plenty of exceptions, but we observe that most are not the types to own yachts or to buy islands or extravagant chateaus abutting St Tropez, Damien Hirsts or other conventional trappings of the super-rich. Private jets are the exception, but we have observed that most VC or LBO GPs with a private jet will have a corresponding discounted cash flow model on an Excel spreadsheet justifying that jet versus public airline travel on the basis that it materially contributes to performing their job more effectively. They do not think of it as so much a luxury, but rather a sensible business investment. Not only do they tend not to spend it, but we also often find that they do not plan to pass on large amounts to their children or other heirs. Wealthy PE GPs tend to be very concerned about the damage that wealth can do to the next generation. In Partners Capital's role as advisors to the wealthy PE GP set, we find ourselves in many deep philosophical discussions about the children of PE GPs. Most want to see their children making it on their own, fighting for their own success with no "unfair advantages" provided by their parents beyond the values, work ethic and education they have armed them with.

So PE GPs save a lot of their wealth. They don't spend it and they don't necessarily plan to give most of it to their children. One might attribute this in part to the "luck" element of their wealth accumulation as they feel they have to make sure this wealth goes to a good purpose. They are healthy and fit and 45-70 years old, feeling that there is not necessarily a rush to establish the charitable foundation or other means by which they will deploy this capital to making a difference in the world. Our observation is that most are a bit "stuck" about where this wealth will be deployed. There are many notable exceptions, where charitable outflows are substantial and personal foundations with clear objectives have been established. But it is our observation that there are far more examples where the path for how the wealth will be deployed is unclear, or the purpose of the wealth is not well defined. This eventually rights itself, but often too late for the creator of the wealth to have an active involvement in determining how it will best be used beyond their lifetime.

The final characteristic of PE GPs that is highly pertinent to their personal investment strategies is that they are extremely "time poor". Even if they are near the higher end of the wealth spectrum for PE GPs, they will rarely have found the time or desire to establish a formal family office. Any free time away from the pressure of deals is usually spent with family and friends, not fretting over how they invest or spend their personal wealth.

The Four Phases of the Private Equity General Partner' Personal Account Investment Strategy

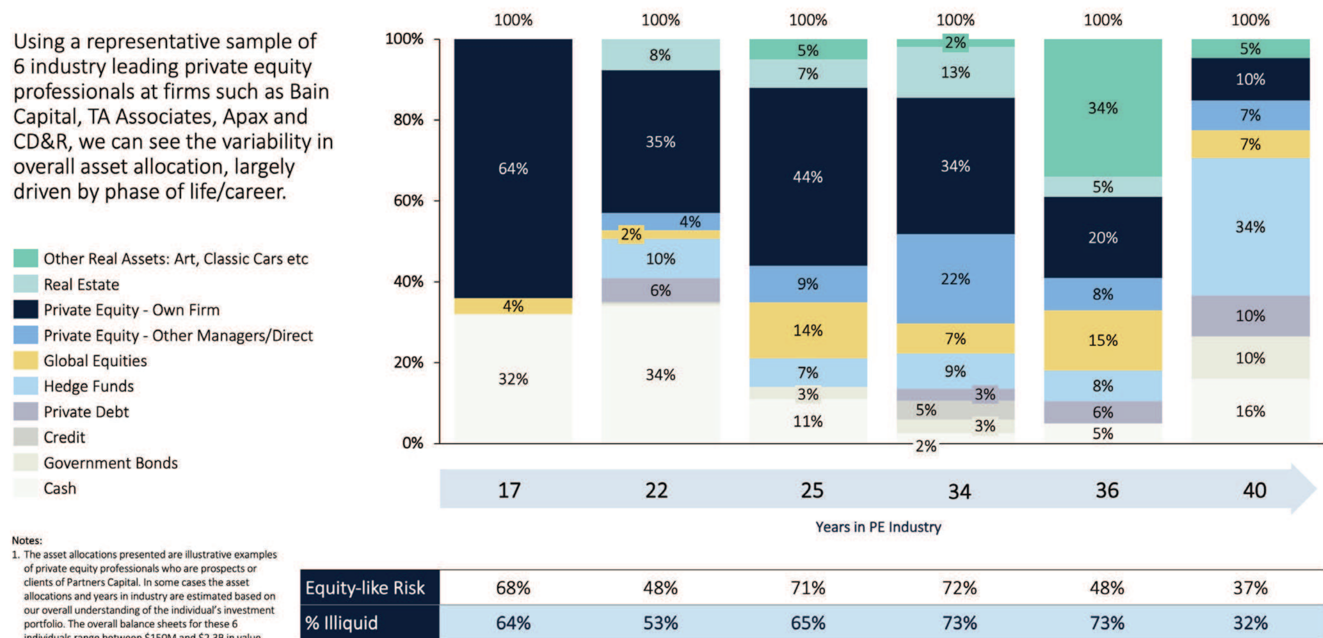
Like any first-time wealth accumulator, there is an evolution of PE GP's risk profile and investment strategy over time which is also influenced by the growing size of their balance sheet. Our PE GP clients often ask what other of our PE clients are doing and, at first glance, there would not appear to be a pattern. In Exhibit 1, you can see that a sample of six of our larger PE GP Clients (AUM from $150M to $2.3B) shows little consistency. However, the more you study the data, patterns do emerge.

After 20 years of growing older and wiser with our PE GP clients, we do see a pattern, especially if you overlay the point at which the PE GP is in their career. There would appear to be four distinct phases which explains much, but by no means all, of the variation. In Exhibit 2, you can see an overview of the four phases.

Phase I: The Bar Bell Phase

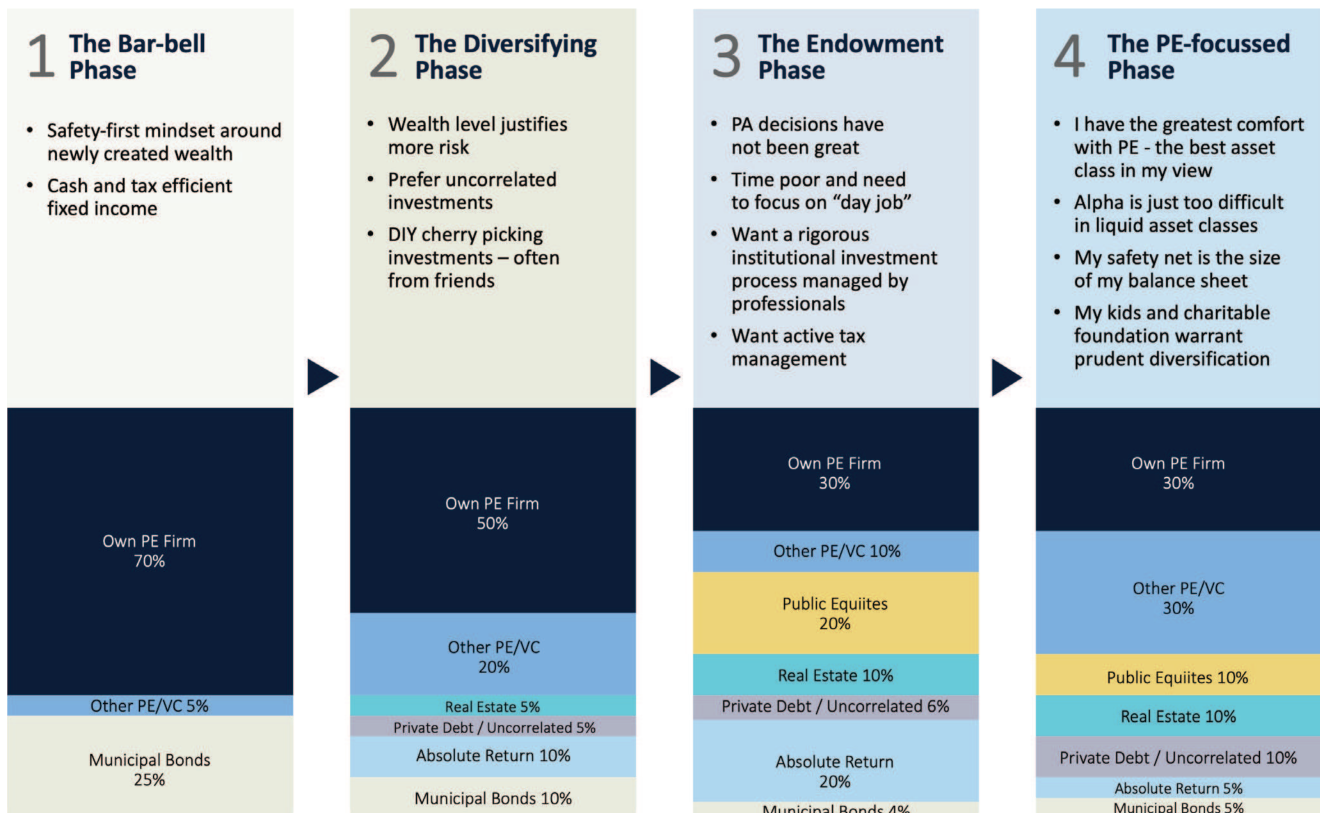
As highlighted above, what dominates the PE GP mind-set when it comes to their personal account investing is "what was hard won can be easily lost". So there is an overwhelming conservatism that dominates the early years of wealth accumulation. This is what we call the "bar-bell" investment stage. The PE GP has finally stopped pouring every penny back into the next fund being raised or co-investment offered, and they have decided to start saving assets away from the high risk of leveraged private company investing. There are education expenses for children to think about, although current income is usually more than ample for the worst-case requirement for living expenses. But the PE GP believes that anything could go wrong in the economy or in the firm which could make it all disappear and it is time to put something aside. The intrinsic caution PE GPs demonstrate in the preservation of their wealth has the PE GP thinking this wealth should be invested in the safest of investments. For US taxpayers, municipal bonds are the classic safe end of the barbell; or similar investments for taxpayers outside the US e.g., in the UK, gilts. Investment grade bonds or even leveraged loans familiar to the PE GP are

Exhibit 1: PE GP's asset allocations differ based on their career stage; increasingly diversifying exposure away from their firms



Source: Partners Capital

Exhibit 2: The Four Phases of PE GP's Personal Account Investment Strategy



Source: Partners Capital

often viewed as the highest risk investments they feel they can make at this stage of their lives.

Phase II: The Diversifying Phase: Uncorrelated Cherry-Picking Strategy

The years pass and the PE GP continues to see extraordinary pre-fee returns from their PE firm/fund distributions and the scale of their wealth crosses a certain threshold. It is generally at this point in their personal investing lives that the PE GP becomes increasingly frustrated and dissatisfied with the paltry levels of post-tax returns of their bond ladder portfolios. They generally have gained confidence in their own general investment skills and decide they will carve out a bit of time to focus on making a small number of investments in uncorrelated funds (usually hedge funds) drawing from their business school, investment bank and private equity network. The scale of wealth means that they can take risk, but only risk that is ideally less or even negatively correlated with their huge private equity exposure. This is the "uncorrelated cherry picking" stage of their personal investing experience. Several years of investing in this manner pass and the track record is not great, often with significant "bombs". It turns out they were overly concentrated in a few funds that are surprising correlated in their investment outcomes during market stress. To make matters worse, it became apparent that what appears to be uncorrelated is usually horribly tax inefficient, often attracting maximum income tax rates as uncorrelated hedge fund, credit and liquid property assets are light on long term capital gains. In addition, the absence of a clear strategy with clear risk management, asset allocation, position sizing and other trappings of good institutional investing are embarrassingly absent.

Phase III: The Institutional Investor Phase

The wealth has grown, the PE GP is still time poor, but the experience of phases I and II has taught them that part-time investing is challenging and

that it is time to embrace a more professionally planned-out approach that is consistent with the “institutional scale” of the PE GP’s overall balance sheet, with a growing share of that balance sheet moving away from the firm to their personal account assets. The PE GP is constantly reminded of how they have generated the private equity gains in the first place; that is by adhering to a highly professional investment process. They come to realise that such a process is what they need going forward for their personal assets. Estate planning has a role and the completion of the estate plan usually provides a relatively rigid structure within which the portfolio can be managed in a more institutional fashion.

Many PE GPs sit on institutional investment committees (e.g., for their alma mater’s endowment, a hospital foundation, a museum or art foundation) and have become exposed to what good institutional investing processes look like. They realise the cherry-picking approach has to be replaced with something professionally managed against a clear set of investment objectives and policies. It is at this point that the PE GP feels the pressure to be more thoughtful about the purpose of their assets going forward and recognises that that capital is bound for long-term purposes and so should be managed with a long-term time frame, that is managed like an endowment or foundation. However, the PE GP is still in their prime and is distracted from the “day job” by this need to professionalise the management of their personal balance sheet.

There are several choices at this juncture for managing the PE GPs personal assets:

1) **Establish a family office** and potentially scale back work with the PE firm and focus more on managing family assets. They feel they must step back from the PE firm they helped to create, to responsibly see that the capital they have accumulated is invested and spent in a way that will make a difference for family objectives and charitable causes they care most about.

2) **Outsource to one of many outsourced CIOs (OCIOs) or wealth managers** with clear scope and principles for managing those assets such that time required is minimal and they can focus on their day job as a PE GP.

   OCIOs themselves come in many shapes and sizes, from small US-only boutiques to globally spanning firms that are similar in scale and reach to the Yale endowment, and from ‘one-size fits all’ funds to bespoke multi-asset class portfolio providers.

3) **Work with the employer PE firm on creating some form of firm investment office (FIO)** where you trust that this internal firm resource can manage your personal assets as well or better than the outsourced alternative. This option might also better accommodate personally sourced investment opportunities than an OCIO or wealth manager can.

The big decision is about the family office at this stage or the type of OCIO they wish to employ. The question is, do they have enough wealth to hire a team comprised of experts on portfolio construction, asset allocation, risk management, tax optimisation and the ins and outs of each of the major asset classes..... and which can provide global coverage, and does not cost too much? There are various estimates of what the breakeven family office AUM is that range from $1B to $3B. As investing complexity grows, with more complex asset classes, more challenges to outperformance, and more tax, asset allocation and regulatory complexity, the breakeven scale grows. Regardless of whether the portfolio is managed with internal or external (outsourced) investment resources, the portfolio generally starts its multi-year program of investment to achieve the optimal long-term allocation and construction during this third phase of the PE GP’s wealth management.

The firm investment office has historically been viewed as a distraction by private equity firms and they have shied away from building such a unit internally. The different needs of the senior and more junior partners has made it difficult to find one size and shape of portfolio that fits all. However, this picture may be changing to the extent that the recent extraordinary level of private equity realisations has created this “personal assets conundrum” earlier in the PE GP’s career – while they are still 110% dedicated to getting deals done and managing portfolio companies.

There are a handful of successful examples of internally managed firm investment offices. Bain Capital started their FIO in 2005, focused on complementary ("uncorrelated") investments in emerging markets, property and idiosyncratic alternative asset classes such as litigation finance. Sequoia Capital launched Sequoia Heritage in 2008 to invest current and past Sequoia partners' capital outside of the Sequoia VC funds. After a challenging start on the team building front, this has become a success, managing $16B, with 60% of that being managed for approximately 20 external investors.[2] Many of those external investors are former CEOs or senior management of successful venture companies. Having them invested in this way with a larger portion of those founders' balance sheets may keep them longer in the Sequoia ecosystem for redeployment in future ventures. Over half of the assets in this portfolio are invested in non-Sequoia private equity, with a bias towards co-investments. So, Sequoia Heritage is not a classic endowment portfolio.

Other firms who have built some form of FIO include General Atlantic and Summit Partners. Perhaps the best model with the longest track record is the McKinsey Investment Office or MIO. While not a PE firm, the MIO has provided an excellent service with outstanding returns for McKinsey partners.

Phase IV: The PE-biased Phase: but with legacy, personal causes or giving back in mind

In this final stage, the veteran PE GP is generally still benefitting from what may be a large but shrinking tail of private equity distributions, but they have enough of their balance sheet outside of firm invested PE assets, that the portfolio is balanced across all asset classes in a tax-efficient manner, accessing many of the best asset managers in each asset class. There is a migration to more, not less, PE as the employer-based PE rolls off. There is a growing relative dissatisfaction with the difficulty of generating consistent outperformance in liquid asset classes, public equities in particular. The size of the overall balance sheet also warrants a higher illiquidity budget, affording more private equity and property investments.

[2] As at 31 March 2022.

Retirement from the PE firm that the GP helped to create can happen during any one of the phases above. What we generally see is PE GPs gradually moving away from the "mothership" and turning their attention not to their balance sheets, but to everything else - which is in effect putting in place the platform for the next 20 years or more of their lives. We rarely see PE GPs taking a "cold turkey" approach to the move away from PE investing altogether. Some never really leave it, but most see it gradually replaced with other activities around "going plural" with a combination of family, corporate and not-for-profit board roles, part-time charitable endeavours, travel and hobbies. As the share of the time pie shifts increasing toward the pluralistic model, the things that matter most become apparent and a clearer purpose for the capital appears. Then their attention is turned to their "family endowments" and using the gains (and possibly the principal) in a well-thought through multi-year program to make the difference they seek to make in their communities or more broadly.

Conclusion

Many things in life we learn from our own journey, when we should be able to learn from others who have gone before us. This goes for parenthood, marriage, healthcare, careers, travel and most aspects of modern life. We hope that our deliberate attempt at stereotyping our core client base and their approach to personal investing is taken in the spirit of learning what may (or may not) be the journey on which you embark as you move your personal priorities from earning to deploying the capital you have worked very hard to accumulate.

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