Setting a Portfolio's Long-term Illiquidity Budget

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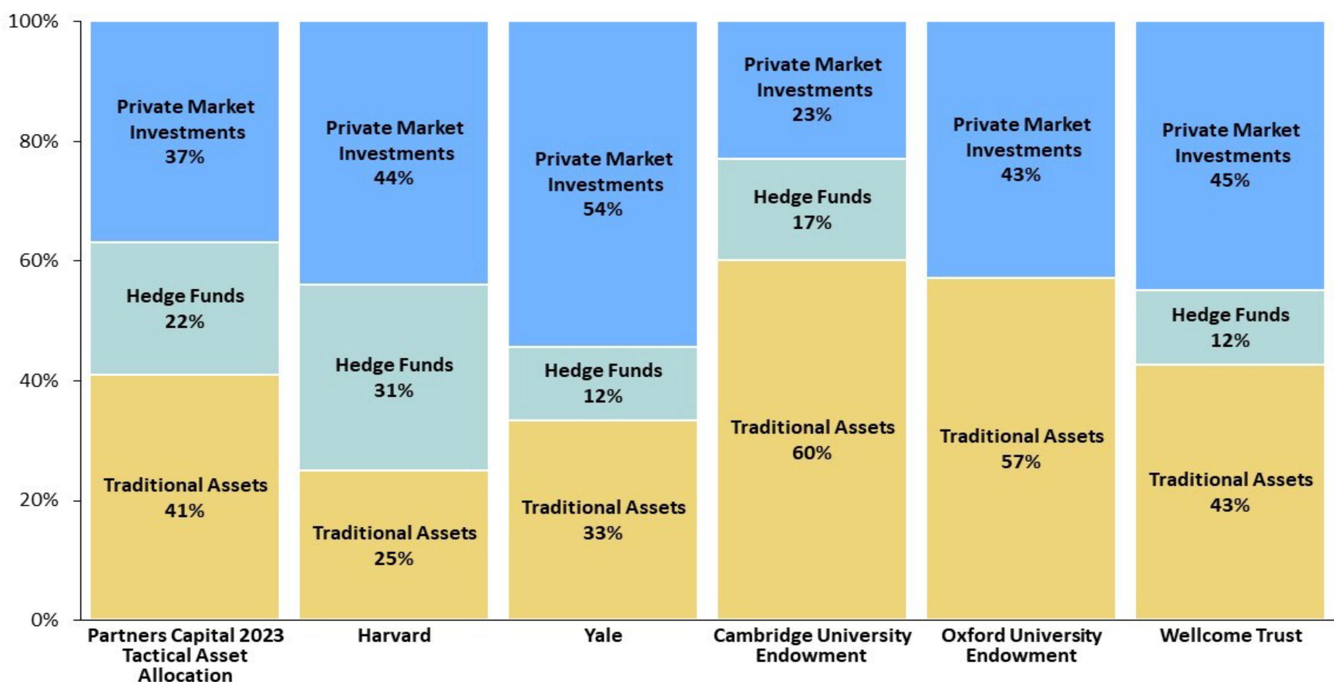
The top performing endowments and foundations generally exploit their long-time horizon with sizeable allocations to Private Equity, Real Estate and Private Debt, enabling them to harvest the illiquidity premium and greater alpha potential that we believe to be inherent in the more inefficient private markets. Our latest 10-year forward looking capital market assumption expect 2.5%-4.0% illiquidity premium depending on private asset class. Therefore, we expect portfolios to pick up c. 0.3% extra return for every 10% they allocate to private asset classes with limited additional risk as measured by equity risk level or volatility.

The Partners Capital Tactical Asset Allocation (set for the average client) currently has a 33% allocation to these three private market asset classes. However, a number of the top performing endowments of educational institutions in the United States, for example the Yale University Endowment, have allocations to private markets above 50%. Exhibit 1 below includes examples of the asset allocations of both US and UK based endowments.

The most appropriate allocation to illiquid private market assets for a specific portfolio varies depending on the following factors:

1. **Spending levels:** We budget for base level liquidity to fund 7 years of spending. So if an endowment has a 5% spending rate per annum, we set aside 35%.
2. **Private market capital calls vs distributions stress scenarios:** In market crisis, calls usually are accelerated to take advantage of distressed prices and distributions dry up because exit prices are not attractive.
3. **One-off capital draw needs:** e.g., debt repayments, capital project funding.
4. **Forecast donations, revenues and other inflows.**
5. **Rebalancing:** When there are big changes in relative valuations of asset classes, we need daily or weekly liquidity in order to respond rapidly to rebalance portfolio back to target allocations.
6. **Currency hedging:** Liquidity is required for margin calls against currency hedging forward contracts, which reduces the potential illiquidity of a portfolio. However, our modelling suggests long-term investors are better of maximising illiquidity before setting currency targets. See our **A Practical Guide to Hedging Foreign Currency** Whitepaper and Appendix C in particular.
7. **Other factors unique to the portfolio.**

Exhibit 1: Current Private Markets allocations vary among the leading endowment portfolios between 23% and 52%.



Source: Partners Capital **Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future performance.**

Various scenarios are generally run to stress test the portfolio for the maximum allocation to illiquid asset classes without encountering a situation where illiquid assets have to be sold, likely at a heavy discount, to meet liquidity needs. These stress tests are not dissimilar to how central banks stress bank balance sheets for financial crisis scenarios.

Partners Capital has built a portfolio liquidity model to determine the maximum private market asset allocation for a portfolio based on the factors above. This model tends to suggest that the average long-term endowment can withstand 40% to 50% of the portfolio being allocated to illiquid private investments. Exhibit 2 shows a typical stress test applying the model and arriving at a maximum allocation to illiquid private investments.

Theoretical Maximum versus a Practical Target

While our experience would almost certainly suggest that sizeable allocations to private markets are possible, and indeed advisable, we are also cognisant that for many fiduciaries, a new allocation to illiquid investments comes with considerable concerns. As such it is not uncommon to start with an allocation well below the potential maximum, which allows the fiduciaries to gain both experience and ultimately greater comfort allowing for a larger allocation in due course – it is much easier to increase an allocation to private markets than prematurely unwind one.

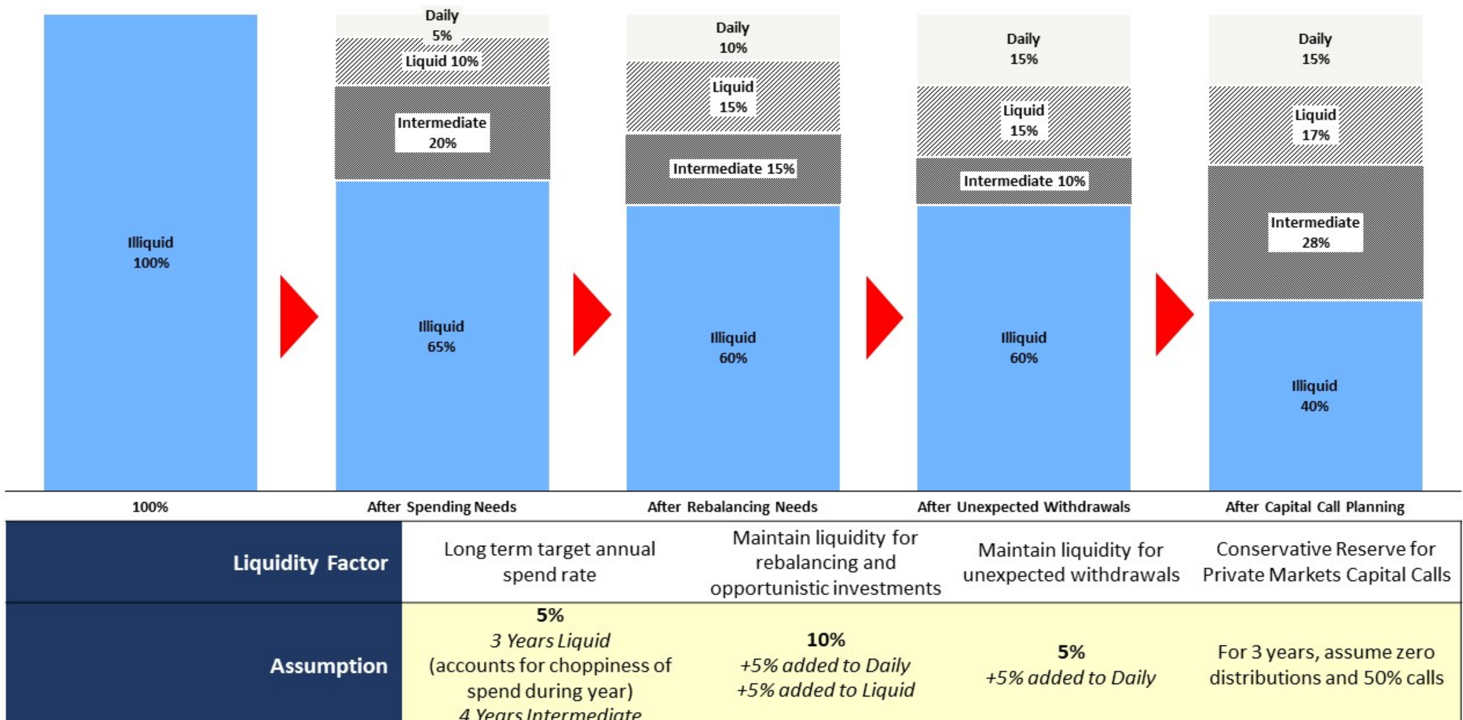
Even amongst institutions with high levels of experience, comfort and willingness to allocate a significant portion of their portfolios in private assets, fiduciaries must be prepared to weather significant swings in their percentage allocation to illiquid asset classes, especially in times of market stress.

Given private markets are often slower to take markdowns than their public counterparts, exacerbated by lagged reporting, there will likely be a quarter or three where private assets are held broadly flat, while the rest of the portfolio is in freefall. This temporary effect can inflate the allocation to private assets within a portfolio by c. 10% for larger allocations.

Exhibit 3 shows how an example portfolio at its current target level of 40% illiquidity would become nearly 50% illiquid in a 2008 Global Financial Crisis style scenario before private assets were marked down or any actions were taken in the portfolio. Once the private assets were correctly marked, this would readjust to c. 42-44%. Note that the impact of the portfolio's current tactical skew away from private equity in favour of private debt increases the level of illiquidity at the end of the stress period.

In our experience, it is in the depths of a market drawdown where fortunes are made and lost. We stress test our private allocation against such scenarios in order to prepare our clients for what can happen and rehearse planned responses with them so that we have the best chance of making clear-minded decisions in those periods of acute stress. Given the near impossibility of timing entry into and out of private markets with the business cycle or macroeconomic events, we recommend a consistent steady set of annual commitments be made which results in spreading exposure evenly over long periods of time – what is referred to as "vintage diversification." Historically vintages deployed during and just after a crisis are the best performing ones, but not so reliably as to have us over-allocate during a crisis.

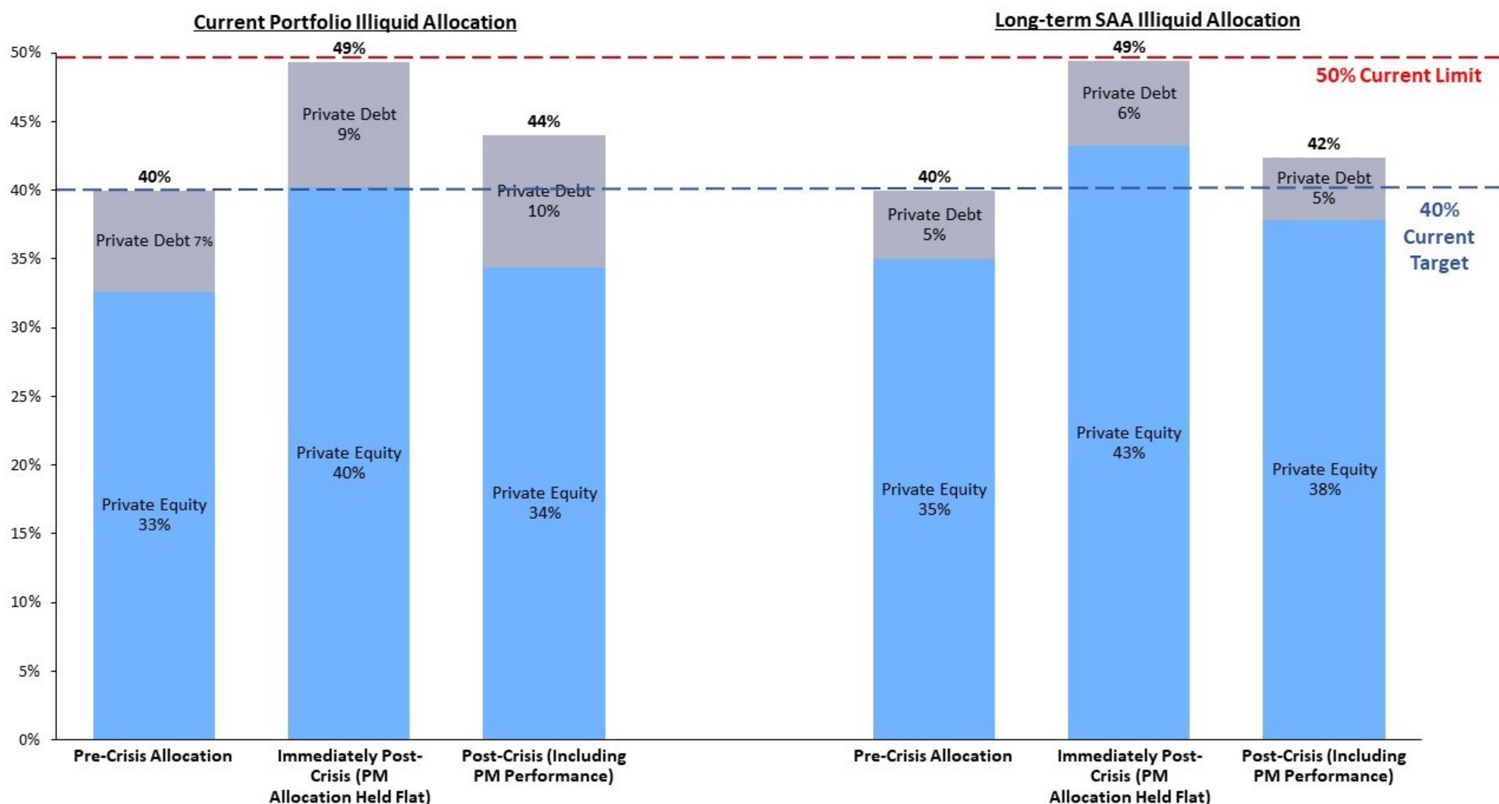
Exhibit 2: The Partners Capital Liquidity Stress Model is shown below for a typical educational endowment arriving at a maximum illiquid private asset class allocation of 40%.



Liquidity Factor	Long term target annual spend rate	Maintain liquidity for rebalancing and opportunistic investments	Maintain liquidity for unexpected withdrawals	Conservative Reserve for Private Markets Capital Calls
Assumption	**5%** *3 Years Liquid* (accounts for choppiness of spend during year) *4 Years Intermediate*	**10%** *+5% added to Daily* *+5% added to Liquid*	**5%** *+5% added to Daily*	For 3 years, assume zero distributions and 50% calls

Source: Partners Capital

Exhibit 3: Portfolio Illiquidity can rise by as much as 10% in periods of market stress.



Source: Partners Capital

Having a rigid policy of sticking to planned multi-year private markets commitments means that we and our clients will not be alarmed in a crisis in a way that influences our investment actions in the private markets part of the portfolio, avoiding discussions of sales of private assets in the secondary markets. If anything, a crisis is a good time to be buying secondaries and we have been known to shift allocations in favour of secondaries when steep price discounts appear.

Planned overall private markets allocations will need to be modified in cases where valuations settle and the private markets allocation has shifted up or down by a significant amount. In those cases, any adjustments to the multi-year commitment plan are made mathematically to hit the long term target allocation often within the constraints of a hard upper limit (a point at which there is a moratorium on further commitments) as shown in Exhibit 3. Informed by our analysis, fiduciaries know they have a sensible target around which the allocation might drift by+/- 10% in certain scenarios. But they are also comforted by the fact there is hard limit preventing the allocation rising too far beyond the point at which their institution may not be able to meet their obligations.

Constructing Private Markets Portfolios

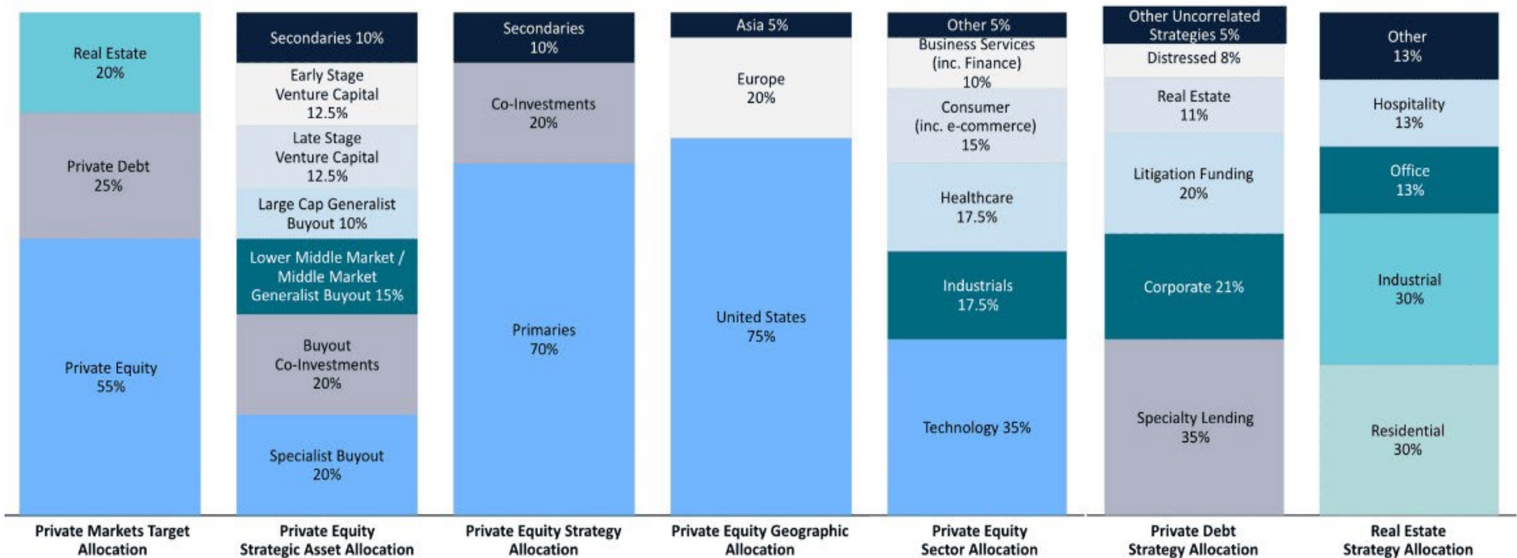
Once we have set targets and/or limits for a private program, we logically turn to its construction. Our private markets portfolios are constructed with defined target allocations across the sub-asset classes, as well as within each sub-asset class. Specific allocation targets are set for geographic, sector, primary vs. secondary private equity and direct private co-investment exposure. We dedicate significant ongoing analysis of the private equity opportunity set across lower middle market buyouts, specialist buyouts, large-cap generalist buyouts, growth equity, early-stage venture and late-stage venture capital and set target allocation ranges based on expected long-term returns, the risks and return correlations for each strategy. Exhibit 4 provides you with an illustrative allocation of a $500M private markets portfolio across all of these important dimensions. It is our contention that these target sub-asset class allocations will have the greatest impact on the private markets portfolio's long-term performance. These allocations should not be random outcomes from manager selection decisions, but rather the opposite. Manager decisions should in some large part be guided by where the portfolio is underrepresented vs the targets.

Private markets are more diverse and more opaque than their public counterparts. The process of constructing a portfolio of these assets involves a deep understanding of the structural dynamics of these different private marketplaces. We have a dedicated team of 31 investment professional researching these markets to help get this right for our clients.

Postscript – Evergreen Funds

The illiquidity budgeting framework above assumes the majority of private asset classes are accessed by traditional drawdown structured funds (i.e., through capital calls). The one exception is that we assume private debt (or c. 20% of the overall illiquid allocation) can be accessed in an evergreen format. Evergreen vehicles remove the need to manage liquidity for capital calls, increasing the maximum illiquidity a portfolio can tolerate. Should an institution have broad access to evergreen structures that meet their needs, it could significantly increase the potential allocation to illiquids. In the example shown in Exhibit 2, the portfolio could tolerate as much as 80% in illiquid assets, depending on the exact redemption/run-off terms of the evergreen structures used.

Exhibit 4: Illustrative $500M Private Markets Portfolio Construction



Source: Partners Capital

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