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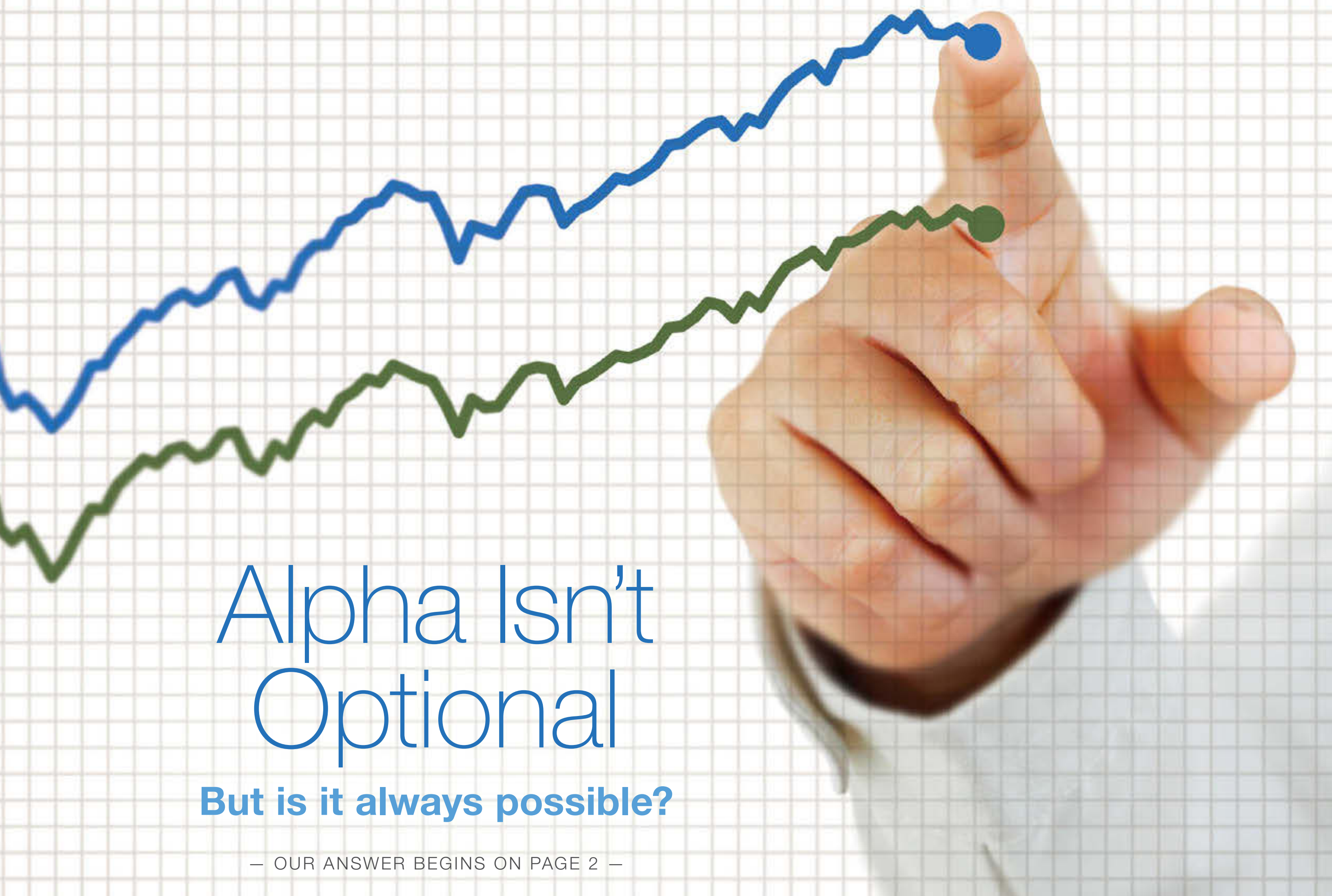
PERSPECTIVES



Alpha Isn't Optional

But is it always possible?

— OUR ANSWER BEGINS ON PAGE 2 —

Alpha Isn't Optional

But Is It Always Possible?

As equity markets continue to rise and investors see an increasing percentage of their returns driven by beta, some investors are asking if active management is a thing of the past.

BY KRISTA MATTHEWS

WITH THE S&P RETURNING more than 225% since March 2009 and continuing to reach new all-time highs, the search for alpha in the US equity market has felt more like a wild goose chase for some investors since the financial crisis. A dominant and highly correlated US equity market and widely available credit has created limited opportunities for market dislocations, making it difficult for active managers to generate above-market returns. This has left many US investors wondering why they should diversify outside the US or bother with the search for alpha at all.

All of this has led to more capital flowing into index funds or index-related investment vehicles.

In second quarter 2014, the Vanguard 500 Fund, which mimics the S&P 500 Index, took in $14.3 billion compared to just $4.0 billion during the same time period in the prior year. In 2014 alone, Vanguard's assets under management as a whole increased by nearly $445 billion.

Given a market environment in which investors have seen US equities dominate, and the resultant momentum toward indexing, should investors focus less on diversification and alpha generation and rely more heavily on US equity beta returns?

Not so fast, says Max Senter, a Chief Investment Officer at CA Capital Management, Cambridge Associates' dedicated outsourced investment office business unit. "We have not had a low return environment since the global financial crisis," says Senter. "That isn't going to perpetuate. Alpha acts as an additional incremental return source over and above what the beta gives you. Beta is going to give you a disappointing return in a low return environment, making alpha all the more necessary."

Celia Dallas, Chief Investment Strategist at Cambridge Associates, agrees. With the inevitable cyclicality of markets, the one thing that is certain is that the bull market will not last forever.

"Alpha doesn't scale with beta, so it becomes a smaller percentage of returns when beta is very high," says Dallas. "But experienced investors know that trees don't grow to the sky. High valuations today in US equities, most sovereign bonds, and some credits mean that we should expect future beta returns to be lower than what we have seen. This will make it challenging for investors to be able to meet their spending requirements without cutting into future purchasing power. Two things that can help bridge the gap are finding sources of alpha and diversification."

But if alpha is necessary to generate attractive long-term returns, is it always possible to find?

The Search for Alpha

"If alpha were easy to find, it wouldn't exist," says Dallas. "But where you do find it, it should be relatively consistent over time and not vary with market conditions."

Senter relies on three general sources to generate excess return for his clients' portfolios: strategies, managers, and tactical tilts for opportunistic investing. While opportunistic investments tend to be more episodic and reflect a quarter or less of the alpha generated in his portfolios, the biggest drivers of alpha generation are selecting the right growth strategies and identifying managers that can outperform the market.

Senter highlights private investments as a growth strategy for generating long-term returns. Indeed, a review of Cambridge Associates' data on the top quartile institutional performers over the last 20 years showed an average allocation to venture capital and private equity of 14.2% for these investors as of December 31, 2014. In contrast, the bottom quartile's average allocation was 4.3% for the same time period.

While hedge fund returns have lagged US equities by a wide margin in recent years, Dallas says that many investors have continued to add alpha using hedge funds. She stresses the importance of keeping hedge fund returns in context as well. "It's important to remember that hedge fund managers invest globally and are typically taking a quarter to half of the equity risk of major equity indexes," she says. "Even as hedge funds add 200 or 300 basis points of alpha, investors should not expect the performance of those funds to keep pace with the long-only equity markets simply due to their risk profile." Senter concurs, and he remains confident that hedge funds will continue as a leading strategy for alpha generation as the current market cycle ages.

Even as managers in some asset classes have struggled to generate alpha, a significant number of managers are still generating returns in excess of the markets, insist Senter and Dallas. The key is finding them.

"There's been a lot of research trying to really understand how to stack the odds in your favor to find managers with sustainable sources of alpha," explains Dallas. "Our research, and broader industry research more recently, indicates that to really outperform, it is helpful to find managers that look significantly different than their benchmarks."

This concept, known as active share, aims to measure the proportion of a manager's holdings that are outside the market. Dallas indicates that skilled managers with high active share have shown a higher propensity to outperform the market.

Senter uses the same approach when building portfolios. "My inclination toward active managers on the public market side is really toward managers that have high active share," says Senter. "They tend to be smaller organizations, often where the founder is an investor first, so

Max Senter

they bring their investing acumen to bear. They are often boutiques that have one or two products and don't dilute themselves. Their businesses are structured to be consistent with best interests of investors. We very much like that."

Dallas notes that managers with high active share tend to maintain their proportion of active share consistently over time. This proves useful

> *"As long as they can stay true to the process, a broad swath of active managers can generate outperformance."*

when conducting *ex ante* analysis to help identify managers that are likely to outperform in the future as well. It also, Senter believes, will be those managers that drive long-term performance. "While some of these managers may not have beaten the index in the most recent time period, when we eventually have a dislocation in the stock market, I think these managers will be well positioned to generate long-term returns that will be well above the fees they charge," he says.

In addition to looking at managers' active share to help identify the outperformers, Dallas highlights other important aspects to consider when undertaking comprehensive due diligence on potential investments. "On the fundamentals side, we are looking for managers that have high conviction in their positions, adding to positions when market pricing improves rather than giving in to agency behavior of selling into a falling market out of fear of looking bad to their client base," explains Dallas. "We seek to understand how they add value, what kinds of risk premiums they are trying to capture, and whether their edge is sustainable. We also need to have confidence in their risk management and portfolio construction as well as in their back office."


Celia Dallas

Fees are always an important consideration in manager selection as well. "Investors should focus on maximizing net returns," says Dallas. "But in a low-return environment, fees are a certainty. Alpha is not. You need high conviction in the ability of managers to outperform net of fees even more so in a low-return environment. Low, but fair, fees are helpful too. Or better yet, fees over an index-based hurdle so you only pay performance fees for value added above the market."

While plenty of managers are consistently generating alpha, finding them is not a simple task. For investors that are committed to generating long-term performance in excess of the markets, it is critical to have the resources in place to identify these managers. "You need to have a world class research effort to be able to evaluate the best array of managers that are all seeking to outperform the market," advises Dallas. "We work hard to find alpha and have made significant efforts over the course of our existence to better understand where managers are adding their value."

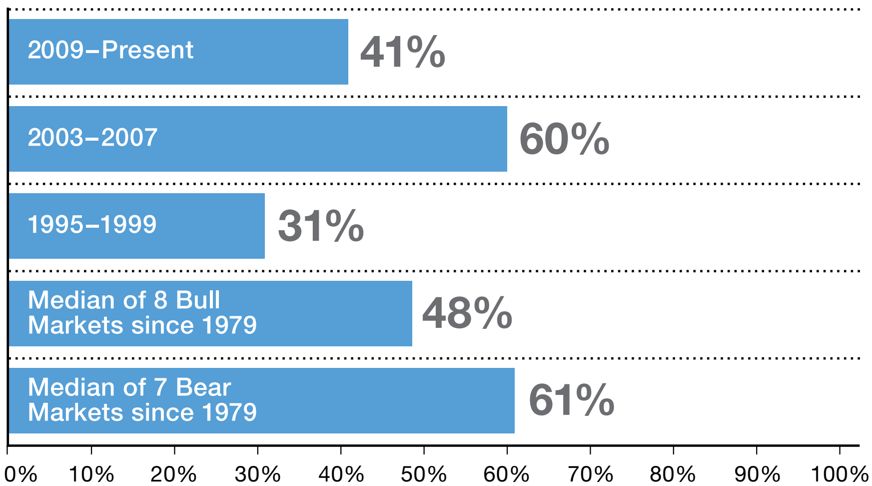
Senter concurs. "As long as they can stay true to the process, a broad swath of active managers can generate outperformance. But you really have to have the research capability to identify those managers out of the thousands of managers out there."

Through it all, investors should not lose sight of the most important determinant of long-term success: strategic asset allocation. "Strategic asset allocation is so important because it is built around the structure of the investor's enterprise and their risk tolerance," Senter says.

Dallas agrees. "If investors get the strategy right, they have a very good chance of meeting their long-term objectives," she says. "If they get it wrong, it could result in devastating circumstances for an institution, even if markets do what we expect them to do over the long term, because the institution won't have the right risk/return profile for its needs."

Outperformance in Bull Markets Is Tough

Percentage of Active US Mid- to Large-Cap Equity Managers Outperforming the Russell 1000®



Sources: BofA Merrill Lynch, Cambridge Associates LLC, Frank Russell Company, and Thomson Reuters Datastream.

Notes: CA's manager universe statistics are derived from CA's proprietary Investment Manager Database. Performance is generally reported gross of investment management fees. Managers that do not report in US dollars, exclude cash reserves from reported total returns, and have less than $50 million in product assets (for 1998 to the present) are excluded. Returns for inactive (discontinued) managers are included if performance is available for the entire period measured. Bull markets are characterized by annual stock market returns greater than those available from money market instruments; bear markets are the converse. The manager universe is composed of managers in the mid- to large-cap universe. We have added 70 bps to the Russell 1000® Index average annual compound return (AACR) as a proxy for manager fees.

Taking the Long-Term View

Looking ahead, Dallas and Senter warn that investors need to be prepared for an environment in which they might not earn what they spend as equity markets inevitably fall and capital market return expectations are tempered. During times like this, they stress, investors must keep an eye on their long-term objectives.

"This is all part of understanding and setting strategic asset allocation," explains Dallas. "A portfolio that's designed to deliver a 5% return after inflation will inevitably have periods in which it doesn't meet the goal and then periods where it earns much more than that return. That's why focusing on the long-term horizon is so crucial."

Senter says that he is having similar conversations with his clients to remind them of the long-term nature of the markets and how alpha is generated. "Our job is to steer them through these bouts of negative relative performance to ensure they reap the long-term rewards of active management," he says.

Investors should also remember that cycles like this are nothing new. As markets get more expensive, their future returns will inevitably fall to the other side of the distribution curve. For asset classes like US equity, Dallas says we are getting closer to that point in time. "It's critical for investors to understand that so they are not chasing after what's been doing well lately and potentially making their returns worse by overweighting the most expensive assets in a lower return environment," she stresses.

To maximize chances of long-term success during various market cycles, Dallas and Senter emphasize the importance of both governance and discipline. Educated investors understand the decision making related to what they own, why they own it, and how that fits in with both their long-term and short-term objectives. This makes them more likely to weather storms of underperformance and resist behavioral tendencies to chase returns. "It can be hard to resist the urge to chase after whatever the latest fad has been when some of those strategies that have a long-term horizon are taking time to bear fruit," cautions Dallas. "That is why discipline is particularly important."

Read more about active share in CA's research paper Hallmarks of Successful Active Equity Managers*, available on CA's website*

Cambridge *Conversations*

Steve Nelson

Head of Portfolio Services

BY KRISTA MATTHEWS

In this multi-part series, CA Perspectives speaks with a member of the firm's leadership to discover what's new and learn more about what to expect going forward.

What is your background at Cambridge Associates?

I joined CA in 1998 as an investment associate. In 2000, I had an opportunity to help create a business plan for our initial entry into Asia, and I eventually relocated to Singapore in early 2001 to help launch the effort. What we originally envisioned as a two-year assignment turned into seven terrific years spent working with clients, developing our research program, and building out our presence in the Asia-Pacific region.

I returned to the United States in June 2008 to co-lead the firm's advisory practice. When Portfolio Services was formalized as a new business line in late 2013, I was asked to lead the group.

How is Portfolio Services structured? What does it encompass?

The business line is relatively new, but the activities that fall under its umbrella have been core components of our work for years.

The foundation of Portfolio Services, the "engine room," is our data and reporting operation. This team is responsible for collecting, maintaining, and sharing our manager-related information across all asset classes on a global basis, in addition to our client-specific reporting.

We also have a team dedicated to our digital product line, which we collectively refer to as CA Portal. This includes Research Navigator (proprietary manager research and due diligence), Benchmark Calculator (private investment performance data), and Peer Data (comparative institutional investor performance, asset allocation, and other data). This group stays close to both internal and external users of the platform to ensure we evolve these products in a way that brings the most value to investors.

How does Portfolio Services integrate with Global Investment Research?

It is a very active two-way street. Our Manager Information Group partners closely with our Research team to make sure that we have the necessary information on hand to evaluate managers, identify trends, and deliberate on investment strategy issues.

Research Navigator is an important avenue for publishing and delivering our investment and operational due diligence, both to our investment teams and to clients directly. It's the window into our manager research program, and it requires a close collaboration between these two groups.

How do investment teams use the platform to build portfolios or make recommendations for their clients?

With most new client relationships, we begin with an investment planning review, which includes setting investment objectives and asset allocation policy. For investment teams, our peer data is an important resource in establishing context, describing the evolution of portfolio structures over time, highlighting current practices, and facilitating a discussion around the choices available to the particular client.

Research Navigator is used daily by most investment teams. It provides the most up-to-date information and commentary on strategies and managers that are currently included in their clients' portfolios. And it provides the basis for future strategy or manager recommendations. It is the book of reference for forward-looking assessments of managers that investment teams are evaluating for inclusion in a portfolio.

Benchmark Calculator is targeted specifically at private investment programs. Within that application, investment teams can create a customized frame of reference for answering any number of questions that clients might ask about the performance of their private equity programs.

Can clients directly access the research and tools offered on the CA Portal?

Absolutely, and we have been pleased to see more and more clients making use of the platform. It is also worth noting that all of our clients benefit from our research platform whether or not they directly access the applications.

Some clients have internal staff with whom we partner closely to provide comprehensive, proactive advisory services. In those cases, staff members can access our applications to further their own research or help frame questions that they then discuss with their CA investment team. The tools become a real extension of their ongoing conversations and another way of facilitating information sharing.

In other cases, very large investment offices with significant internal staff and expertise may not require an intensive advisory relationship with CA, but they value the research platform that we've developed over the years. They recognize it would be near impossible to re-create the scale and depth of our research. So, their primary point of connection with CA is through these applications. They can stand on the shoulders of Research Navigator or Benchmark Calculator to inform their investment decisions and further their own investment programs.

What are your short-term and longer-term visions for your team?

Our short-term vision starts with creating a better experience for the users of our applications, particularly focused on our clients.

We deeply believe that our research and data have always been among the best in the industry. With the CA Portal, we've renewed our commitment to ensuring that our technology is as good as the content it delivers. Usability, performance, ease of access, consistency of experience—these are all areas that we are focusing on in terms of the current development agenda. Users saw our first step in early May with the launch of the new integrated Portal and redesigned application interfaces. They should expect to see more enhancements later this year.

Longer term, we see the potential of creating an integrated workspace for our clients. A comprehensive system for portfolio monitoring, market and manager research, risk assessment, and workflow management simply does not exist in the institutional market. Investors are forced to cobble together information from multiple applications, and for data analysis, inevitably port it all over to an Excel spreadsheet. All of this requires time and effort that might be more productively dedicated to investment issues; not to mention the cost and complexity of managing multiple vendor relationships. We want to create one place that investors can visit to complete the full range of portfolio management tasks.

> *"First and foremost, if we're not contributing to good investment outcomes for our clients, then we're not doing our job."*

How is the platform different from others in the industry?

What users of Research Navigator and Benchmark Calculator have at their fingertips is very difficult to replicate. We have invested heavily in our manager coverage, particularly in alternative assets. We have built that up over many years and on a global basis, in no small part due to the nature of our client base. We work with some of the most sophisticated investors in the world, investors that are among the most desirable clients to investment managers. That has afforded us a level of access to the manager universe that is unique.

Other due diligence platforms focus on providing the largest number of due diligence reports they can possibly create. But the world has become much more complex and the number of opportunities for institutional investors has grown. You can simply push information into investors' hands, but the vast majority of that would be noise. We're not in the business of creating *more* noise for our clients. We piece out what we believe will be most relevant and impactful to them, and where we have the highest conviction. The end result should be a higher hit rate on matching client objectives with the right investment strategy and product.

Finally, our library of 30-plus years of comparative institutional portfolio data helps distinguish our digital tools. The current and historical portfolio information paints a picture of how others have addressed asset allocation issues and provides another lens through which investors can test their own portfolio construction decisions.

What can clients expect from the platform going forward?

We are very excited to launch a pilot of our online performance reporting application this summer. It will be a meaningful upgrade, and it is an important piece of the puzzle in making our platform a truly comprehensive set of portfolio management tools.

Clients can also expect to have the ability to run a more robust set of analytics over time, both from a manager evaluation standpoint and also from a portfolio analysis perspective.

Social features are on our radar as well. We've seen firsthand through our client conferences and forums how valuable it is for clients to interact directly with one another. We are fortunate to serve some of the best investment practitioners in the world, and we learn from them every day. We want to extend that benefit into a digital community for our clients, giving them the opportunity to share insights or bounce ideas off one another, making the platform an interactive experience.

Looking even further ahead, we want to test the idea of allowing clients to bring their own information into the applications. One example might be inputting client-specific manager meeting notes. This would allow clients to easily move back and forth between our research and their own to have a single source for accessing the information they need.

These are just a few of the ideas I am excited for the team to explore. Of course, all of these ideas will be enhanced and fleshed out in our ongoing conversations with clients, as we learn more about what they would find most valuable.

What do you consider the most important measurements of success for your team going forward?

First and foremost, if we're not contributing in a tangible, positive way to good investment outcomes for our clients, then we're not doing our job. Everything is in support of that. Our tools should help our clients and our internal investment teams spend more time on investment thinking and decision making, and less time searching for and assembling information.

We also need to continue to evolve the products in the way that best meets our clients' needs. That will require an even deeper level of engagement with clients, understanding how they use the tools and where they are struggling to complete tasks. If we can keep pace with that—accepting that it will be a process, not a destination—then I think we stand a good chance of success. ■

To learn more, visit the CA Portal when you log into the client section of the CA website

CLIENT PROFILE: *The Nevada System of Higher Education*

Making the Grade

As Nevada's only provider of public higher education and one of only four states with a publicly elected board, Nevada System of Education faces some unique opportunities and challenges in its pursuit of investment success.

BY ANDI POLLINGER

FOR THE MAJORITY OF STUDENTS pursuing higher education in the United States, public institutions remain a high-quality yet affordable choice for obtaining a college degree.

Meanwhile, state funding for higher education has declined significantly since the financial crisis of 2008–09, putting pressure on public colleges and universities to seek private sources of funding. But the ongoing national debate about student debt and the cost of college have slowed tuition growth. These trends are shifting the business model and raising important questions for how US public higher education funds its operations.

The Nevada System of Higher Education is exploring solutions to these challenges. The System is the only provider of public higher education in the state of Nevada. It serves more than 100,000 students and includes eight underlying institutions that roll up under one publicly elected board of 13 Regents.

In 1985, policy changed to establish foundations at each of the underlying institutions and allow each of them to raise funds from alumni and their local community of donors separate from the System. Assets received prior to 1985 remained with the System endowment. Today these foundations have assets ranging from $8 million to $147 million. The System endowment remains the largest of the pools at approximately $220 million, but conducts no fundraising activity of its own.

Nevada is one of just four states (Colorado, Michigan, and Nebraska are the others) whose board is publicly elected rather than appointed. This structural profile creates some unique issues for the Nevada System that *CA Perspectives* discussed in a recent interview with Vic Redding, Vice Chancellor of Finance and Administration, and Kevin Melcher, Regent and IC Chair.

Describe some of the benefits of having a higher education system for these eight institutions.

REDDING: Having these institutions under one system facilitates common course numbering and transfer of credits among our institutions. There are potentially some synergies in the management of cash both in our endowment pool as well as our operating pool. As vice chancellor of finance, I oversee all the mechanical details and issues that make those pools function under direction of the investment and facilities committee of which Regent Melcher is the chair.

MELCHER: Each of the Regents represents approximately 220,000 people as of the last census: nine Regents from Clark County (where Las Vegas is) and three that predominantly represent western Nevada.

And then there is my district. I live in the northeastern corner of Nevada and was elected from 11 of Nevada's 17 counties, encompassing just over 93,000 square miles. Even though we're elected from different parts of the state, we operate as one governing board that oversees all eight institutions.

What are some of the characteristics of an elected Board of Regents?

MELCHER: When you have appointed boards, you can be very specific in the expertise you need. We have a good mix of people but not necessarily with expertise in finance or investments. For instance, I'm a K–12 educator and I've learned a lot about finances in a hurry.

"Managing that friction between intergenerational equity and today's needs is clearly a balance that will continue."

REDDING: The Board of Regents is also the Board of Directors for the underlying foundations.

The smaller endowments must have some challenges investing their funds. Is the System endowment an investment option for the smaller foundations within the System?

REDDING: Frankly, given the size of the System's endowment, we have access to investment vehicles and some economies of scale that a small community college foundation might not have. We've begun an initiative to introduce the System endowment as an investment option for these smaller foundations. We have nothing to gain centrally. It's just an initiative to put a little more money in the pockets of the institutions.

MELCHER: From time to time we get donations to the System endowment. For instance, we just received a donation through Truckee Meadows Community College at the donor's specific instructions. But it's not a formalized arrangement for all donations to Truckee. I see our offer to the institutions as a way for them to outsource the investment management of their funds. Not only could it provide them with greater returns, but perhaps allow them to re-allocate staff resources toward other projects.

Vic Redding

How has your focus on the endowment changed over time?

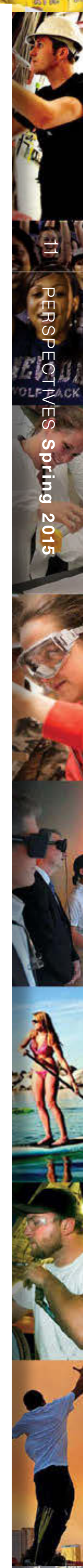
REDDING: Like almost every higher-ed system in the country, we have experienced significant cuts in state funding. Overall the System has about $1.5 billion a year in operating funds, about $500 million of which comes from the state. So, roughly a third. That $500 million number is well below what it was prior to the recession. We lost $210 million of our state appropriation.

We don't expect to see budgets returning to those pre-recession levels and that's really given us a renewed focus on finding every efficiency that we can squeeze out of the System. One of the discussions we're having is around the best way to manage invested funds.

MELCHER: One of the things that we deal with here, which I know a lot of other states do also, is the open meeting law, or the Sunshine Law as it's called sometimes, and how that affects our ability to act quickly. Even if our Board or finance committee meets to make a change, we have to have it ratified by the full board. So if we needed to move on something quickly, we would have to call a special meeting of the Board to take action. That's a real challenge for us, especially with the type of experience among our Board members. On top of that, we have turnover on the committees because every June we redo them. So we have to ask ourselves, at what point are we willing to give up some authority in making some decisions so that we can take quicker action? That's why we're looking at different ways to operate. We just gave Vic and his staff the green light to come back to us with plans for that at our next Board meeting.

What are a few of the options you are considering?

REDDING: In Nevada, we're kind of in that Goldilocks dilemma. If we were a very small endowment, I think the outsourcing discussion would be straightforward. If we were a very large endowment, then we'd probably have our own staff. We're in that grey area where the decision is not so cut-and-dry. Consequently, we're evaluating the outsourced CIO option to determine if this might be a fit for an elected governing board.



Kevin Melcher

MELCHER: We're also looking at an option to add ex-officio members to our investment committee who have the investment expertise we need to be able to advise us on a more consistent basis. Regardless of the management model we choose, we also have to consider what responsibilities the investment committee would keep and which to outsource.

If you were to change your model of endowment management, how would you ensure continuity as newly elected Regents join the Board?

REDDING: Our handbook is our governing document and has been in place since 1985. Any changes that we're contemplating would ultimately result in a change to that governing document.

What does Nevada have in common with other public systems of higher education around the country?

MELCHER: Last September, at the CA Trustee conference, we participated in a roundtable discussion led by Tracy Filosa of CA's Enterprise Advisory team. We learned that we deal with a lot of the same issues that other higher-ed institutions deal with: lower state revenues, the need to do more fundraising, and the changing economy in the markets that we serve. We also learned that a lot of people were glad they didn't have our governance structure. And we were glad we didn't have some of their issues. For example, one institution oversaw 40 foundations, which seemed impossible to me!

What is the goal for the System pool?

MELCHER: Our goal hasn't changed. We want to invest the money as safely as possible while generating the highest returns for that level of risk. What concerns me most is having consistent governance over the portfolio, especially since we're asking these foundations if they'd be interested in investing their funds with the System. It puts a little more responsibility on us.

Are there other factors influencing your decision?

REDDING: When this structure was set up in 1985, the investment world was simpler. I think we had six managers at that time and an endowment that was right around $20 million. We have almost 40 managers now. On top of that, there are alternative investments, global opportunities, and asset classes that nobody even imagined would exist 30 years later. I have an extremely small staff and the legal and regulatory reporting requirements have also become more significant in recent years. All these factors require that our governance approach is set up appropriately.

What trade-offs are inherent in changing your model of investment management?

REDDING: I spent a number of years on campus before I came up to the System office. When I'm on campus, I see the needs. I want to get as much money out there as possible to make an impact today. But the investment committee is charged to maintain intergenerational equity so that our successors and our successors' successors have the same purchasing power and ability to move the needle when they're sitting in the seats we have. Managing that friction between intergenerational equity and today's needs is clearly a balancing act that will continue. ■

Read more from CA's Enterprise Advisory team in The Missing Metric for Endowment Growth: Net Flow Rate, *available on CA's website*

Taking the Wheel: What's Driving the Co-Investing Trend?

An increasing number of investors are exploring co-investing as part of their private investment strategy. But is this approach right for everyone?

BY CARYN SLOTSKY

CO-INVESTING IS ENJOYING a moment in the spotlight, but it is actually one of the oldest private investment strategies next to fund investing. Whenever managers have insufficient capital to complete investments they want to make, they seek co-investors. This happens across the industry, at all tiers, and at varying costs of access.

As private investing has evolved over its roughly 30 years of institutional history, co-investing has become more prevalent. Two primary factors have driven this "mainstreaming": the reduced cost of access and the resulting increased return potential and the ability for investors to have a greater element of control over the deployment of capital in their private investment programs.

Co-Investment Has No "Height Requirement"

There is an impression that only large investors can really have active co-investment programs, says Andrea Auerbach, Managing Director and Head of Global Private Investment Research at Cambridge Associates. This is due in part to the additional expected resource requirements and perception of required program scale to make a co-investment allocation meaningful. At least one recent study, *The Disintermediation of Financial Markets: Direct Investing in Private Equity* by Lily Fang, Victoria Ivashina, and Josh Lerner, reinforces this perception. The study showcases seven investors with an average of nearly $21 billion in alternative assets under management making co-investments with an average size of more than $48 million. But an analysis of 139 co-investments in Cambridge Associates' database indicates that co-investing is available for programs of any size. In fact, just over 20% of the these transactions were less than $5 million in size, and more than 60% were in opportunities of $25 million or less in size.

Reduced Fare

"Co-investments provide a reduced cost of access to an investment strategy with a robust return profile," says Auerbach. According to information from CA's private investment database, the long-term median return of global private equity hovers between 10% and 11% on an internal rate of return (IRR) basis, net of fees, regardless of fund size. Auerbach explains that the average return spread between gross fund IRRs and net fund IRRs for US private equity is approximately 7%, but ranges from 2% to 25%. "For many programs, recapturing some of that spread via co-investing can have a meaningful impact on performance," she says.

Taking the Wheel

Investors have come to recognize that co-investing is one of very few tactical levers available in the private investment realm, with another being the purchase or sale of limited partner interests via secondaries. "For most other forms of private investment, the key decision of when to invest capital is squarely in the hands of the general partner," says Auerbach. "Within a certain time frame and with certain exposure limitations, a GP is well compensated to make a series of decisions that culminate in an investment return for the LP. Through co-investing, LPs can gain greater control over the deployment of capital in a portion of their program by making individual private investments and taking on the investment responsibility that accompanies them, albeit at a reduced cost of access."

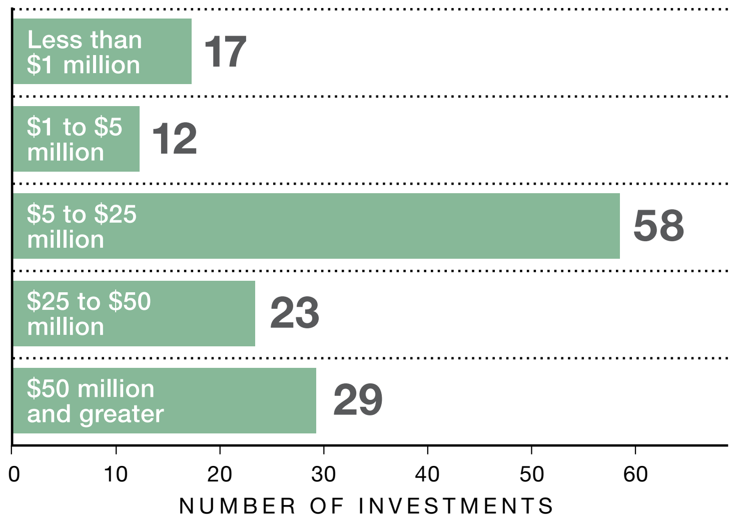
Investors can calibrate the type of co-investments desired for their private investment program across many attributes, including:

- lowering cost of access;
- increasing exposure to investments that meet specific risk/return parameters;
- increasing investment exposure to certain managers;
- increasing exposure to investments meeting any combination of sector, geography, enterprise size, or other relevant parameters; and
- increasing exposure during certain valuation environments.

Auerbach stresses that this last point should not be underestimated. Volatile markets often cause a retreat of capital and a reluctance of many to act. Yet these are typically also times when valuations improve. "Investors that are prepared to pursue co-investments in those environments, within their established guidelines of course, may enjoy less competition from others and create more goodwill with managers that could benefit the broader program in myriad ways," she says.

Given the program-specific aspects of co-investing, the result can be a "portfolio" of

Co-investment Transaction Volume by Investment Size



Source: Data from Cambridge Associates LLC's proprietary private investment database.

co-investments occurring over a long period of time with potentially varying characteristics as program needs evolve. This can make comparisons to a more traditional fund structure difficult. Given the level of customization, the hallmarks of a successful co-investment effort are investor specific and can be defined using a range of quantitative and qualitative attributes appropriate for that program, explains Auerbach. It is entirely possible for one program to seek to preserve capital at a cheaper cost of access and therefore have a different risk/return expectation for co-investing than another that is purposefully focused on higher risk/return potential co-investments, also at a cheaper cost of access. Both are viable strategies and success can be defined and measured differently. "Co-investing adds complexity to a program and can defy comparison," stresses Auerbach. "It is certainly something to consider before getting behind the wheel."

Read more about co-investing in CA's research report Making Waves: The Cresting Co-Investment Opportunity, *available on CA's website*

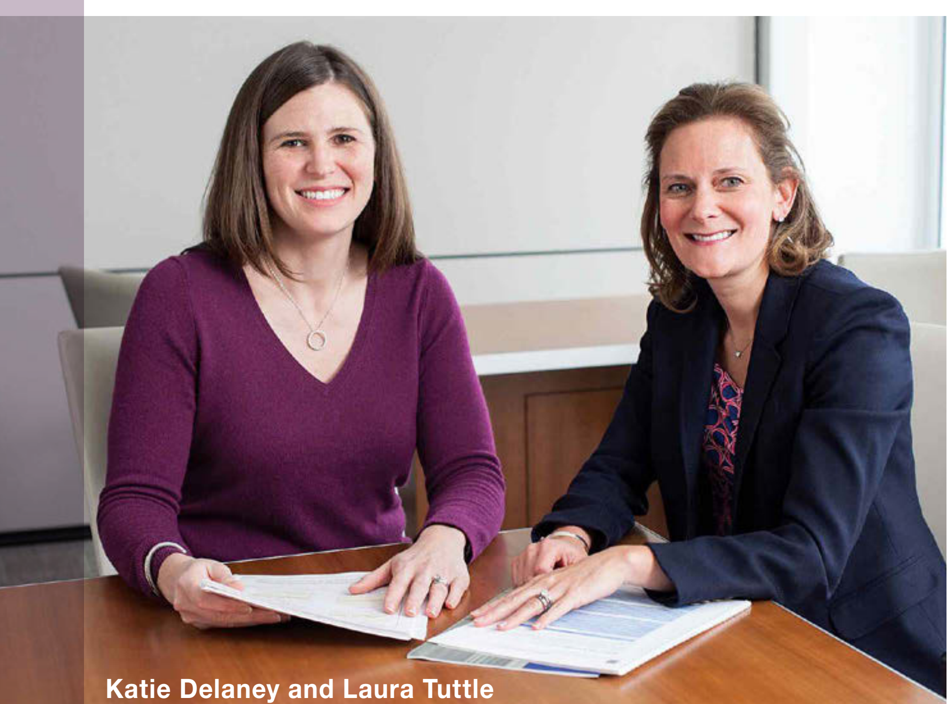
Educating Your Successors

Talking to the next generation about wealth can be difficult for many families. But will keeping silent do more harm than good?

BY PAMELA GALBATO

I DON'T WANT TO RUIN MY KIDS. I don't know where to start. I want to avoid family conflict. Parents teach their children to talk, walk, and navigate the world, but when it comes to educating the next generation on the family's wealth, many families fret. Speaking about money is uncomfortable, generational planning can be arduous, and families fear demotivating their children.

Yet, however daunting these conversations may seem, avoiding them can be a disservice to families by putting the next generation at risk of not being ready to assume their inevitable wealth and responsibility. "If the generation transfer happens unannounced and without discussing the plan, the children will be unprepared," says Laura Tuttle, a Managing Director in Cambridge Associates' Private Wealth practice. Echoing these sentiments, Doris Carter*, a Cambridge Associates client, shared her thoughts on the importance of educating the next generation. "You just have to do it. The next generation will not be able to responsibly manage their inherited assets unless we teach them how." While hesitant families are wise to be thoughtful about their approach to generational planning and wealth education, their conundrum should shift from "*why and if*" to "*when and how.*"


Katie Delaney and Laura Tuttle

When?

Ascertaining the appropriate timing is a good first step. Although family situations vary, "wealth education generally begins as the successors are reaching transitional periods, like graduating from college or getting married," shares Tuttle. These transitions tend to spur questions about the family's wealth and estate plan. In fact, many of Cambridge Associates' family clients currently have children going through these transitions and may find that the right time is fast approaching.

How?

After establishing a time frame, families should develop a plan. "Some families delay educating their heirs because they are uncertain of where to start, how to approach the conversations, the correct order, and what information to share. Thinking through an approach and developing a method can help begin and ease the process," advises Katie Delaney, a Managing Director in Cambridge Associates' Private Wealth practice. When planning for the education of the next generation, Delaney and Tuttle suggest families take some key considerations into account.

1. **Determine what you want to share and how you want to share it.** Families may effectively approach generational planning by thinking through the topics they'd like to discuss, in what order, and how. Delaney recommends that families consider what makes the most sense for them. "Education and generational planning can be gradual. Some families choose to start educating their children on investments prior to disclosing the wealth. And some start a family foundation and give their children responsibilities that help educate and reinforce family values," she says. Carter shares that it is important to plan ahead and entice the

next generation. Beginning at age 18, her family's heirs go through a boot camp focused on understanding financial fundamentals. Interested heirs then have the opportunity to complete a summer internship in the family office or become involved in one of the family's philanthropic endeavors.

In many families, the next generation is composed of individuals from the millennial generation—the largest and most diverse generation in history. Ranging in age from 15 to 35, many millennials are experiencing the transitional periods that are the impetus for conversations about the family's wealth. Influencing their values and communication style, this cohort's dependence on technology, access to data, entrepreneurial spirit, and connectedness has defined their generation. Families planning for their millennial successors should take this into account and strive to understand what motivates the next generation as well as what modes of communication work best, suggests Delaney.

2. Plan a family meeting. Tuttle advocates family meetings, which are "a good way for generations to pass on their values and family history." However, she cautions that since "historically families lived closer together, finding a location, setting a date, and getting everyone together is now a very practical hurdle." Carter also faces this obstacle with the next generation in her family. "They're all over the map in terms of location, what they're doing, and what they're interested in," she says. Families can entice the next generation by making the meeting a fun and interesting family reunion, providing the next generation the opportunity to connect with family members they have not seen in years. For example, Tuttle shares that one family client hosts a dinner at a different museum every year the night before the family meeting. Family members and advisors mingle, enjoy a private tour of the museum, and have the opportunity to catch up over dinner.

3. Set the foundation by telling your family's story. "Start with the big picture, focusing on the family values and history," advises Tuttle. Elder family members can pass the torch to the next generation by helping them understand what their generation can do to carry on the family's legacy. "Having the different generations speak about the origins of the wealth and the family's philosophy is a really powerful moment," says Tuttle.

4. Ease into the estate plan with investment fundamentals. Estate plans can be dense and complex. "After you've spoken about the big picture and before talking about the estate plan, educate on trust structures and taxes," advises Tuttle. The boot camp Carter's heirs go through is designed to "really go back to the basics" and covers the fundamentals of accounting, portfolio management, trust structures, taxes, and asset allocation. Setting the proper foundation and ensuring the successors have prerequisite knowledge will make this step more productive and digestible.

While the notion can make parents anxious, engaging the next generation is proving advantageous for families. "We are seeing very positive results from the families that have decided to start the process," shares Delaney. "Children seem to appreciate when parents take the first step, and educating the next generation can bring peace of mind to parents, knowing that their children are equipped to handle the responsibility that will ultimately be theirs." ■

Join Us

Thinking about educating the next generation of your family? We are pleased to announce Cambridge Associates' Next Generation Family Conference being held June 2nd and 3rd in Boston.

The goal of the conference is to educate and prepare the next generation of family members for the future by providing an introduction to capital markets, asset classes, trust structures, socially responsible investing, and other investment-related topics.

Any individual who would like to become more informed about capital markets and investments or who may play a leadership role in management of the portfolio in the future will likely benefit from this unique experience. In addition to educational and topical education sessions, there will be ample time for networking with peers and CA staff. The conference is geared toward individuals who do not regularly attend investment meetings with Cambridge Associates.

Please contact Emily Kruglik (ekruglik@cambridgeassociates.com) for more details.

* Name changed in the interest of the client's privacy.

See Us at Institutional Investor's E&F Roundtable

Four leaders at the firm will present at the Endowment and Foundation Roundtable organized by Institutional Investor. David Shukis, Head of Global Investment Services, will share views on navigating hedge funds and alternative investments. Celia Dallas, Chief Investment Strategist, will lead a discussion on portfolio construction. Meagan Nichols, Deputy Head of Global Investment Research, will speak on real assets and infrastructure investing, and Q Belk, Director of Diversifying Investments, will moderate a session on emerging managers. The event will take place June 3–5 at the Four Seasons Hotel in Boston. For information on how to register for the event, visit **www.institutionalinvestor.com**.

See Us at SuperReturn

Five private investment experts will be featured speakers at this year's SuperReturn US conference in Boston. Marc Cardillo, Managing Director, Real Assets Research, will speak on a real assets panel and Michael Brand, Investment Director, Real Assets Research, will present on the energy fund landscape. Josh Zweig, Senior Investment Director, Private Investments, will give a private equity market data presentation. Scott Martin, Senior Investment Director, Private Investments, will co-lead a master class session on co-investing. The conference will take place June 15–18 at the Renaissance Boston Waterfront Hotel. In conjunction with the main conference, Andrea Auerbach will serve as Course Leader at the SuperReturn Academy for a full-day educational program on co-investing on June 18 at the same location. For more information, visit **www.icbi-superreturn.com**.

NEWSLETTER PUBLICATION

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