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PERSPECTIVES

Private Investing in Focus

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Why it isn't just for the largest investors

Cambridge conversations
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The Grantham Foundation for the Protection of the Environment
Using private investments for returns and impact

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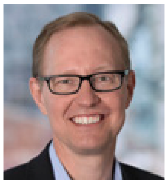


A Message from David Druley

I JOINED CAMBRIDGE ASSOCIATES 13 years ago because I thought it was the best platform for generating excellent returns for the world's leading institutions and wealth owners. I also suspected that I would want to be a part of the firm's outstanding investment team for a long time. Over the years, working with these clients and colleagues, I've been constantly inspired to be a better investor. Being named CEO and Chairman of this exceptional firm is the highest honor.

Over the last several months, as I prepared for this new role, I've had the privilege of traveling around the globe, spending time in our offices meeting with clients and colleagues. In conversation after conversation, I'm reminded why I made that decision 13 years ago. The caliber of the clients we work with is unmatched. In addition, I truly believe that our team is the most talented in the industry. We have the right talent and tools to drive returns for our clients, and our firm continues to attract the industry's best investors. And, many years later, they are still people I'm excited to work beside.

Investing is a competitive zero-sum game, and alpha is the winner's prize. As an investor, I am committed to ensuring that we continually focus on delivering investment results that help you achieve or exceed your investment goals. It is the vision on which this firm was founded more than 40 years ago, and it remains our mission today. I am motivated and energized by the responsibility and opportunity to build on this legacy of success.

As we move forward, we will not lose sight of the fact that your success is intricately tied to our own. Delivering excellent returns and providing unparalleled client service remain our most important goals. As a client of our firm, we hope you feel that we are an excellent partner to you and a good steward of your capital, we take your unique needs and goals into consideration when implementing a portfolio calibrated just for you, and we focus on generating significant long-term value add. We know that your investment success has a meaningful impact on your philanthropic endeavors, on your capacity to meet your pensioners' obligations, and on your ability to achieve your personal investment goals. We are committed to helping you maximize that impact.

Creating portfolios that add significant value requires us to constantly stay ahead in a complex and ever-changing landscape. Information is ubiquitous today, and how we synthesize and vet the information to make smart decisions is really what makes a difference. That is why we will continue to invest in our firm to ensure we have the appropriate strategies and structures in place to deliver for you. This means having robust investment teams that can make informed decisions about your needs, best-in-class investors who will manage your portfolios as if they were their own, and the corporate infrastructure that is required of a top investment firm.

Again, I am truly honored to lead what I consider the best investment firm in the industry. We are incredibly fortunate to work with an unmatched group of sophisticated institutional investors and private clients around the world. We will continue to leverage and enhance our deep global manager networks to find the best investment opportunities possible for you. We will maintain laser-like focus on developing and managing portfolios that are specifically designed with your goals and interests in mind. And we will focus on ensuring that we attract, develop, and retain the most talented investors in the industry who are committed to being excellent stewards of your assets.

I am grateful for this incredible opportunity, and I am committed to your ongoing success.

David Druley

David Druley
Chairman and Chief Executive Officer

Craig Smith and Jill Shaw

Private Investments Are More Accessible Than You Think

BY KRISTA MATTHEWS

OFFERING OUTSIZED RETURNS relative to public markets, private investments have been a key contributor to long-term performance for decades. Indeed, based on Cambridge Associates' research, top-quartile endowments and foundations over the 20-year period ending June 30, 2015, have one factor in common: an allocation of 15% or greater to private investments such as venture capital, private equity, and private real assets.

But for a large subset of investors, private investments are viewed as an elusive, complex investment strategy without a meaningful place in their portfolios. While investors with more than $500 million in assets have an average of 23% invested in private investments, investors with less than $100 million average only 6%.

The Fear Factor

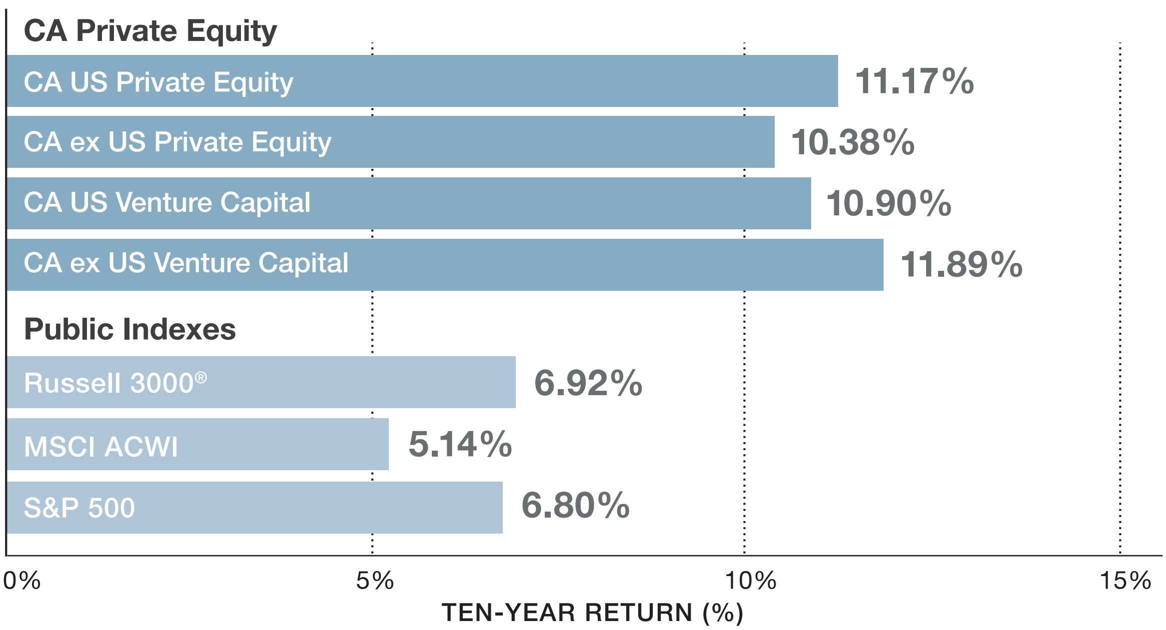
While many smaller investors conclude there are too many barriers to entry, they can and should enjoy the long-term benefits that private investing offers, says Craig Smith, an outsourced CIO in Cambridge Associates' dedicated outsourcing business, CA Capital Management. "The only true restriction to investing in private investments is that, legally, limited partners must be qualified purchasers,"[1] he explains. "Outside of that, there are no hard-and-fast limitations for investors, assuming they know how much illiquidity is prudent and tolerable in their portfolios."

Despite private investments' proven success, many investors cite illiquidity considerations as a primary factor for avoiding private investments. By definition, private investments go through a "lock up" period, which makes the investments difficult if not impossible to sell once an investor has committed to a fund. Compounding that, limited partners must oblige when general partners call capital, which does not happen on a set timeframe. For these reasons, some investors fear that too much illiquidity in their portfolio will leave them vulnerable.

To help clients truly understand their liquidity needs, Smith and his investment team stress test portfolios through a number of market situations to

[1] Qualified purchasers must have at least $5 million to $25 million of investments, depending on the type of investor.

Asset Class Performance: Trailing Ten Years as of 12/31/2015



Sources: Cambridge Associates LLC, Frank Russell Company, MSCI Inc., and Standard & Poor's. MSCI data provided "as is" without any express or implied warranties.
Notes: Private indexes are pooled horizon IRRs, net of fees, expenses, and carried interest. Public indexes are AACRs (time-weighted returns).

understand how the portfolio would react in even the most severe market downturns. This exercise helps investors gain comfort in understanding what level of illiquidity their portfolio could withstand. Using these scenarios and working with investment committees to understand their specific levels of comfort, Smith's investment team documents policy limits for private investment allocations and commitments.

"Many portfolios can easily support at least some level of illiquidity. Once investors understand what to expect from their portfolio and are comfortable that their guidelines prudently reflect their situation, we can craft a private investment portfolio that works for their unique needs," says Smith.

Smith is also quick to remind investors that feel they are too small to take on the illiquidity that it is not an issue unique to them. "Whether your portfolio is $100 million or $1 billion, a 15% allocation to private investments has the same level of impact on the portfolio from a liquidity standpoint," says Smith. "The limitation is not the size of the investor, but the specific dollar liquidity needs of that investor."

Jill Shaw, Director of Private Investments on Smith's investment team, also cites access to top-performing funds as another oft-cited reason why smaller investors shy away from private investing. In this case, Shaw points out that many of the best-performing funds over the long term have been invested by newer managers with smaller assets under management rather than the mega-funds that many investors equate with private investments.

Indeed, analysis in Cambridge Associates' Research Note, "Venture Capital Disrupts Itself: Breaking the Concentration Curse," indicates that 56% of total venture capital gains from 2000 through 2012 came from funds with $500 million or less in assets. "It's important for investors to remember that a lot of the firms that are considered 'blue chip' private investment firms actually made a great deal of their money earlier in their life cycle when they were investing out of smaller funds," says Shaw.

"Firms with fewer assets under management tend to accept smaller commitments from limited partners, making these types of investments a more natural fit for investors that are putting fewer dollars to work in private investments," adds Smith. "If a fund manager is launching a new fund, he or she is likely to want a sufficiently diversified base of LPs," says Smith. "Large investors looking to put hundreds of millions of dollars to work in

> *"Whether your portfolio is $100 million or $1 billion, a 15% allocation to private investments has the same level of impact on the portfolio from a liquidity standpoint."*

private investments are not necessarily going to be attractive LPs to these smaller funds."

While some investors might feel that investing in newer funds introduces more risk, Shaw explains that many start-up funds are simply spin-outs from larger and more established ones. "General partners that created a great track record at a large firm and want to hang their own shingle usually want to start with smaller assets under management to remain nimble and focused," she says. "They are very thoughtful about the LPs they partner with."

Shaw cites an example of a spin-out from a $3 billion fund that raised $300 million in its first round of fund raising. "At that size, they are not porting those larger LPs from the blue-chip fund over to the new fund they started," she says.

Smith explains that smaller investors also have an advantage in private investing when general partners are looking to fill small funding gaps quickly. "Quite often, as managers lead up to a final close, they find themselves with a hole of a few million dollars in their fundraising due to LPs backing out last minute or other extenuating circumstances," he says. "Just by being available and present when those situations happen, we have gotten smaller clients access to great funds that otherwise wouldn't have been open."

Smith also advises investors to keep access in perspective with their actual portfolio needs. While access to every compelling fund might not be possible, it is also not necessary. "For investors with less than $100 million in assets, we are usually making anywhere from one to four new private investment commitments per year. While there might be ten to 20 or so great funds in the market in a given year, we only need to access a couple of them," he says.

A Big Picture Approach

Aside from liquidity and access concerns, some investors have shied away from private investments because of the perceived complexities of constructing a fully diversified program. Historically, investors that thought about their portfolio by asset class "sleeves" have had more of an all-or-nothing mentality toward private investments.

"Many investors have long had the view that they have to build a broadly diversified private investment portfolio within their total portfolio," Shaw says. "For smaller investors that thought they must build a comprehensive, diversified private portfolio on a stand-alone basis, the concept of private investing became much more daunting."

Smith and Shaw credit a shift in thinking more holistically about portfolio construction for helping to better frame private investments for investors of all sizes. Smith and his team build portfolios based on the intended role of each investment within the total portfolio. Instead of having specific targets to private investments, hedge funds, or public equity, for example, they look at a holistic "growth allocation" within the policy portfolio. Looking at the role of the individual investments allows investors to focus on which investments are most likely to help maximize the objectives of the total portfolio.

"Thinking in terms of the investments' role allows us to discuss the expectations and trade-offs of private investments in relation to other options for growth, such as public equity," Smith says. "This has gotten some investors more comfortable with the idea of private investing because they better understand what role private investments will play in their portfolio, and they recognize that private investments have been the better growth driver over the long term."

> *"General partners that created a great track record and want to hang their own shingle usually start with smaller assets under management to remain nimble and focused."*

Thinking in more holistic terms also relieves the pressure on investors to find and access private investments across all strategies in each vintage year. "When we include private investments in our portfolios, we aren't just looking to 'check the box'," says Smith. "It's really about knowing what the most interesting managers and strategies are in the current market environment, focusing more on maximizing those opportunities, and then sizing them appropriately in the context of the total portfolio risk."

For investors on the smaller scale that are making fewer overall commitments to private investments, the focus on strategy and manager selection is arguably even more important. "We are not buying the market, so we have to know which strategies to stay away from and which strategies to lean into in certain markets," says Shaw.

Strategy and Manager Selection Is Key

How then do investors identify the most compelling opportunities?

As strategies go through different investment cycles, Smith and Shaw say it's important to understand where a strategy is in the cycle to determine whether it's a good time to be investing in it. While dollars frequently flow into strategies that have been showing recent success, Shaw explains that Cambridge Associates often takes a contrarian view. The firm's dedicated private investment research team spends a significant amount of time looking at the capital overhang in each private investment strategy to identify those that are less well funded.

"We pay a lot of attention to dollars flowing into various strategies—and we don't want to be part of the trend," she says. "We try to avoid those bubbles rather than play to them."

Shaw uses the venture capital investment cycle as an example. About ten years ago, venture returns were hovering around zero, and four to five years ago it was considered a "toxic" strategy that many investors were avoiding. "That was actually the perfect time to invest," she says. Now that returns have climbed back to attractive levels, investors are clamoring to get more venture exposure, creating a frothy market and overvalued assets, particularly at the late stage.

Another overvalued strategy in the current market is large-cap buyouts. "There are a lot of big players there. They have a lot of money chasing deals. There is a lot of committed capital that needs to be put to work, with fewer companies that fit the bill," Shaw says.

"We pay a lot of attention to dollars flowing into various strategies—and we don't want to be part of the trend. We try to avoid those bubbles rather than play to them."

Shaw cites early-stage venture and energy as two strategies that are currently interesting given more attractive valuations. Focusing on the long-term nature of private investments, Shaw also stresses that the research team looks not just on what might be attractive today, but tries to stay ahead of trends to ensure that investors are well positioned to take advantage of opportunities as the markets shift.

"Right now private credit is not particularly attractive, but our expectation is that it will become more attractive over the next couple of years given near record leveraged buyout purchase prices and debt levels," she says. "That means that we position ourselves today to be ready to identify credit opportunities and get our clients invested in our best ideas as soon as the environment begins to shift."

While identifying in-favor strategies is important, that isn't to say compelling opportunities can't be found in all areas. Smith says it is vital to continually conduct thorough due diligence across all strategies and sectors to ensure that investors don't miss an opportunity to invest with a compelling manager that is capable of bucking the trend in an out-of-favor strategy.

But identifying top-performing managers takes both time and resources. With the sheer volume of funds in the market and the now global nature of the opportunity set, investors that cannot commit the resources to doing thorough due diligence should rely on outside specialized expertise or avoid investing in private investments altogether, advises Smith.

"Unlike in other asset classes, once you invest with a private investment manager, your funds are committed for the long term," he says. "Investors need to have strong conviction that the funds in their portfolio have been thoroughly diligenced and are the opportunities that have the best chance of maximizing their long-term results." ■

Cambridge Conversations

David Thurston and David Shukis

BY KRISTA MATTHEWS

CA Perspectives sat down with David Thurston and David Shukis, both former heads of Global Investment Research who have collectively been at Cambridge Associates for more than 65 years, to discuss their recent publication, "The 15% Frontier." Their analysis indicates that an allocation of 15% or greater to private investments has been the primary driver of top performance for long-term investors.

What are the key drivers of the outperformance in private investments?

THURSTON: The most straightforward answer is the alignment of interest. Private investors tend to take down the money when they find attractive opportunities. That typically leads them to buy things that are relatively cheap, which allows for more value creation.

SHUKIS: In the public markets, companies are tied to quarterly earnings, which can lead management to take a shorter-term focus. Private companies can make more fundamental improvements and potentially take hits in the near term to add long-term value without worrying about what the stock price is going to do.

THURSTON: Alignment is one of the main reasons why we tend to be interested in smaller private funds. For smaller funds, a 1% or 2% management fee is a relatively small amount of money. The real wealth for general partners is created from the incentive. They are not just rewarded for gathering assets. Instead, they are incentivized to generate returns for the client, first and foremost.

SHUKIS: When you read the press maligning the rich compensation that private investment managers get, it misses the point that the 20% profit participation is a huge incentive for the managers to make money for their investors. The fee might be high, but it really does align the investors' interests with the manager's and put the focus on value creation.

THURSTON: There is also a behavioral aspect in private investing. Numerous academic studies show that institutions and individuals tend to buy at highs and sell at lows. Private funds that are "locked up"

"The beauty of the 2000 to 2008 period was it fostered a newer generation of fund managers who developed a skill set to manage through the inevitable weak market."

are run by managers that are incentivized to both buy cheap and sell each investment at the highest possible price. This approach reinforces practices that remove the classic behavioral trap of choosing to buy or sell at precisely the wrong time.

How has the private investment industry changed?

THURSTON: In the 1980s and 1990s, there was a small universe of institutional-quality private investment managers and an even smaller universe of private investors. The 1980s and 1990s were characterized by returns that trailed the stock market. However, after the spectacular returns at the end of the 1990s, assets flowed into private investments and the manager universe grew exponentially.

This was inevitably followed by a market correction and a shake-out in the industry. The beauty of the 2000 to 2008 period was it fostered a newer generation of fund managers that developed a skill set to manage through the inevitable weak market.

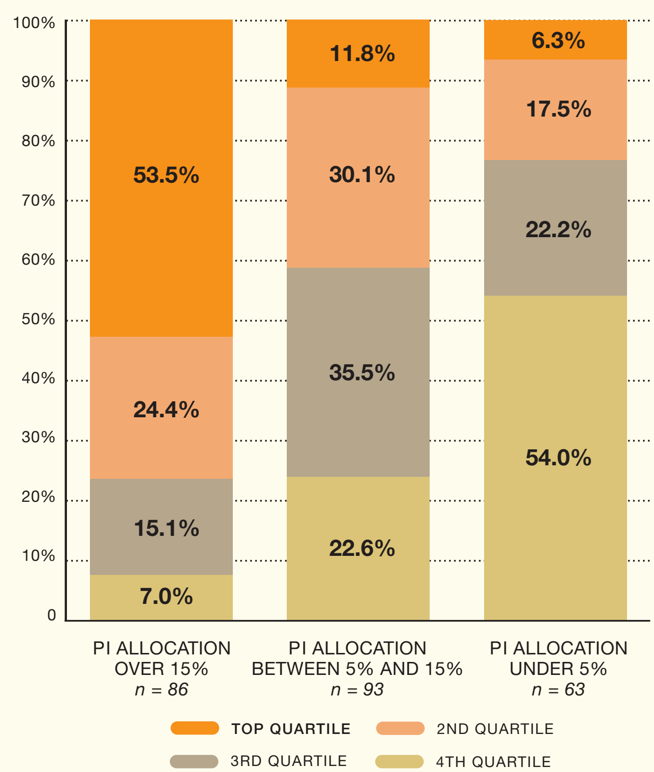
The 1990s generation of risk-taking managers was replaced by a new generation of younger, more knowledgeable, and more highly trained individuals. Now you have risk-oriented, well-diversified, and well-structured funds. The universe of high-quality institutional funds is significantly larger today than in the 1990s.

SHUKIS: Private equity returns have been coming down over time, but that's because it's a different business. The universe of private investment funds offers a wide spectrum of risk and return opportunities, but on the whole the business is more risk controlled today than it was in its early days. It's become a global business run by experienced, professional general partners. Lower risk means you will get lower returns than you did in the 1990s, but the return today may still be much higher than what you get in the stock market.

What's today's outlook? With valuations so high, is it the right time to be investing in private investments at all?

SHUKIS: When investors talk about private investing, they think of it as an asset class. It's not really an asset class. It's a series of discrete investments with various strategies, geographies, sectors, and stages. The funds are very different, and we research and monitor hundreds of them to understand which ones have the best managers, the ones with unique skill sets, and then which sectors have the most attractive valuation.

Over 75% of institutions with >15% PI are in top 2 quartiles vs. less than 25% of institutions with PI allocations <5%



Endowment and foundation data as reported to Cambridge Associates LLC. Notes: Analysis includes 242 endowments and foundations that provided returns and asset allocation for each June 30 from 2005 to 2015. Subgroups are based on each institution's ten-year average allocation to private investments.

THURSTON: Biotech is a great example. In the mid-2000s, investors were extremely negative on health care investing, particularly biotech. We continued to research health care funds and were impressed with the quality of the underlying portfolios. Based on that research, clients maintained exposure with eventual outstanding results. The key is having a long-term time horizon.

SHUKIS: What really matters is that when you're getting low returns from your equities and your bonds, incremental return from active management becomes even more critical. Private investments have consistently been the area that offers the biggest incremental value over market returns. If you had been in the stock market and privates over the long term, your privates outperformed your stocks. What that suggests is if you have a choice of having 20% of your money in privates or leaving that 20% in the stock market, and there's no significant liquidity constraint, you should consider 20% in privates.

THURSTON: The paper focuses on the differential in performance between those with more than 15% in private investments and those with less than 15%. It is our “best guess” that when June 30, 2016, performance becomes available, we will see the spread between those groups grow even wider over the latest ten-year period. Many investors expect that since the returns in privates have been coming down over time, the value added by private investments will shrink. That is the opposite of what we expect. As underperforming years from the early 2000s drop out of the private returns and investors commit higher percentages to private investments, we will continue to see the institutional performance spread widen even more over the coming years.

In the paper, you suggest that investors often place a higher value on liquidity than needed. Why is that?

SHUKIS: Organizations often don’t have a systematic understanding of their overall liquidity requirements, so they overestimate their need for liquidity to be conservative. Historically there's been a lack of integration between thinking about the portfolio and thinking about the rest of the enterprise. People who are responsible for the investments haven’t necessarily thought about

“When you’re getting low returns from your equities and your bonds, incremental return from active management becomes even more critical. Private investments have consistently offered the biggest incremental value over market returns.”

other liquidity needs or liquidity sources outside the investment portfolio. They tend to think they have to account for liquidity needs within the investment portfolio. In fact, there are often other sources of cash within the organization.

Our enterprise advisory team helps investors do a thorough analysis of their liquidity needs. The team can do a battery of portfolio scenario testing to give investors confidence that they know what to expect over time and what they need for liquidity in the worst case.

THURSTON: 2008 had some benefits, and one of the benefits was helping people truly understand their potential liquidity needs. They became fully aware during the financial crisis. Emerging from that difficult time, most institutions discovered that they could manage greater illiquidity than previously thought. Those that did have trouble developed a more sophisticated understanding of their actual liquidity needs and modified their practices. They are now structured to deal with a major market decline, which allows them to increase their private exposure. Since 2008, many institutional investors have meaningfully increased private investment exposure, which has enhanced returns.

Many smaller investors think they can’t successfully access private investments. Is there merit to this argument?

THURSTON: Despite common thinking, scale can be a disadvantage to investing. Smaller investors should perform better in private investing because smaller funds typically deliver better returns than larger ones. For example, better performing venture funds tend to have a fund size of $250 to $500 million. A $30 billion investor is hard pressed to invest in a fund of that size. Large investors have typically had much less allocated to venture. That's not because they are necessarily less interested, but because they just can't access those size funds at a scale that is meaningful for them.

SHUKIS: I think this misconception that private investing is only accessible to the largest investors is a relic of the 1990s, when very large investors were really the only ones investing in the area.

Speaking of misconceptions, is the access constraint in privates real?

THURSTON: Just as the general partners have developed an improved skill set over time, institutional investors that have been investing in this space for a long time have also become savvier at being desirable LPs. They do have advantages in the sense that funds tend to go to them first and foremost.

But there has been a misguided concept for quite some time that the drivers of venture capital performance have tended to be a small handful of bigger funds with high minimums that most investors can't access. Our November 2015 Research Note, "Venture Capital Disrupts Itself: Breaking the Concentration Curse," provided powerful evidence for a new generation of successful funds.

SHUKIS: Some of the funds you can't get into are not funds you necessarily want to be in anyway. There are certainly some great funds that new investors can't easily access. But there are plenty of other great funds that are accessible. You just have to work harder to find them and cultivate relationships with them, and that's what we do on behalf of our clients.

THURSTON: This is where our relationships in the industry have really been beneficial. Most "new" funds are typically partners that spin out from larger funds that we actually have known and built relationships with for decades. Our database also tracks individual deals, so we can look at the track record of deals that a GP has made and understand his or her success rate in making winning investments in the past.

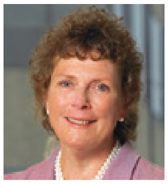
What do investors need to get right to succeed in private investing?

SHUKIS: They have to be long-term investors and they have to be committed to investing a meaningful amount in this area to make it worthwhile. The reason 15% is important is because it is a level that can have a sufficient impact on the portfolio.

THURSTON: You have to work very consistently toward it and be patient. It takes a minimum of ten years to establish a meaningful program. You also have to be selective. What our study shows is that if you are a thoughtful and persistent investor, having private investments is the key driver to better long-term performance. Quite simply, the more investors have in privates, the better they have done. So, first and foremost, focus on your liquidity needs. Also, make sure you have the skill set to identify strong managers or have identified a partner, like Cambridge Associates, with the specialized skill set to identify and monitor the vast global universe of available opportunities.

Learn more about the impact that private investments have had on long-term performance in "The 15% Frontier," available online at www.cambridgeassociates.com.

AFTER MORE THAN 25 YEARS with Cambridge Associates, David Shukis retired on June 30, 2016. As a former head of Global Investment Services and Global Investment Research, David played a significant role in helping to shape the firm's global research platform, particularly in alternative assets. As an investor, a researcher, and a mentor to an immeasurable number of colleagues, David has touched hundreds of CA clients throughout his tenure with the firm. "David's commitment to our mission and core values has been central to his thinking and his actions," Sandy Urie says. "He has been a consummate leader, always challenging conventional thinking and focusing on our clients' needs. He will be missed, but the impact of his leadership will endure."



A Message from Sandy Urie

SEVERAL YEARS AGO, as I had dinner with my then college-age daughter, she said something that surprised me: “When I graduate, I want a job like yours.” It puzzled me because she was an art history major who had never expressed even a passing interest in investing. But then she further explained, “It’s not the kind of work you do. It’s that you wake up every single day excited to go to work. I want a job where I can feel like that every day.”

She was right. After more than 31 years at Cambridge Associates, serving as CEO for the last 16 years, I can honestly say that I am as energized by the work we do today as I was when I walked through the door for the very first time.

When I joined Cambridge, I suspected I was joining a special place. I knew it was a firm with a noble mission and deep values and principles that resonated with me. I was drawn by the firm’s singular focus on delivering investment results for clients to help them do well while doing good. Much has changed over the past 30 years, but the mission that drives us to do our best for clients so they can do good in the world has never wavered.

While 30 years is indeed a long time to stay at one place, I have never questioned my decision to make Cambridge Associates my long-term professional home. First and foremost, we have the best clients in the world. I have spent a great deal of my time traveling around the globe, meeting with many of you to understand your needs and to explore ways in which Cambridge can work most effectively with each of you. I leave those meetings feeling invigorated by my conversations with committed professionals working to achieve superior investment returns. You, our clients, continually challenge us intellectually, demanding the best from us and pushing us to do great work.

I have also had the privilege of working with extraordinary colleagues who I believe are the most skilled and dedicated group of investment professionals working in the industry. The unique culture at Cambridge means that I have been able to learn from valuable mentors and I have had the opportunity to serve as a mentor for others. We wouldn’t be able to deliver on our mission without my colleagues’ unwavering dedication to our clients, and I am grateful to work alongside them.

It’s because of our clients and my colleagues that I am not yet leaving Cambridge. As I transition into my new role as Chairman Emeritus, I will continue to get up every day excited to work closely with our clients all around the world. I will still learn from my colleagues and take pride in watching their hard work result in helping you to meet your investment objectives. And I have the utmost confidence that the firm’s exceptional new leadership team will continue our long legacy of challenging conventional wisdom and focusing on how we can better serve our clients.

It has been a privilege and an honor to lead this firm, and I am enormously grateful for the 31 years—and counting—that I have been at Cambridge. I look forward to seeing what is ahead for all of us.

Sandra A. Urie
Chairman Emeritus

CLIENT PROFILE: **THE GRANTHAM FOUNDATION FOR THE PROTECTION OF THE ENVIRONMENT**

SOLVING FOR IMPACT AND RETURNS

BY LIQIAN MA

CA Perspectives *sat down with Jeremy Grantham, Co-Founder of GMO LLC and The Grantham Foundation for the Protection of the Environment, and Ramsay Ravenel, Executive Director of the Foundation.*

FOUNDED IN 1997 by Jeremy and his wife, Hannelore, the Grantham Foundation's mission is to protect and improve the health of the global environment. In early June, Jeremy Grantham was named a Commander of the Most Excellent Order of the British Empire (CBE) in Queen Elizabeth II's 90th Birthday Honours list for his philanthropic contributions to climate change research.

Jeremy Grantham

What is your vision for the Grantham Foundation?

GRANTHAM: Our Foundation was started to help protect the natural environment from human activity, broadly defined. We have evolved over time, with the central focus now on climate change. We are seeking to address important questions surrounding climate change, such as how to slow it down, bring more public and political awareness to it, and help scientists project their findings.

We also want to help figure out how the world will feed 11 billion humans in 50 years, given the challenges of water scarcity, soil erosion, loss of arable land, and extreme weather that deeply impact agricultural output. Global agricultural productivity gains have declined from 3% to barely more than 1% annually. We use a farm to experiment on sustainable farming and are beginning to explore ways to increase agricultural productivity without heavy reliance on industrial fertilizers.

Through our grant-making, our Foundation has also backed a number of new media and journalism groups to raise awareness of climate change issues, two of which have won Pulitzer prizes in investigative journalism. The Center for Public Integrity reported on systematic misdiagnosis of black lung disease by a doctor at Johns Hopkins. *Inside-Climate News* reported on a diluted bitumen spill in the Kalamazoo River. In total we have supported more than a dozen efforts to balance the amount of misinformation out there funded by the larger and more sophisticated vested interest groups.

> *"We are seeking to address important questions surrounding climate change. We also want to help figure out how the world will feed 1 billion humans in 50 years."*

Being a Brit, I have also backed a number of research efforts in the United Kingdom, including at Imperial College and the London School of Economics where we have established institutes for climate research. Both of these institutes have been reasonably successful, having published influential research and opinions to help guide policy. A related enterprise is the Divecha Center for Climate Change at the Indian Institute of Science, to which we provided funding jointly with my GMO partner Arjun Divecha. Finally, we fund the Grantham Center at Sheffield University, my alma mater, with an emphasis on food and sustainability. Many of these independent centers have started collaborating on ideas and projects.

Nearly everything I've earned goes into the Foundation, and it's the intention of my wife and me to leave almost everything to the Foundation. Not the 50% that some others have pledged, but more like 95%. We're all in.

RAVENEL: Jeremy can personally support efforts that the Foundation cannot pursue for whatever reason, which gives us flexibility. That's very useful. We of course do what we must to manage each pool in a responsible and compliant manner, but in their pursuit of shared values and impact, the personal and Foundation asset pools are mutually reinforcing.


Ramsay Ravenel

You have positioned the Foundation's portfolio with a 40% target allocation to venture capital. Why is that?

GRANTHAM: We share Cambridge Associates' view of having a relatively large share of venture capital allocation. But we share it for different reasons that make the argument even more compelling.

Looking at historical results, Cambridge has shown that institutions with more venture capital have consistently outperformed when you have the right experience and selection skills.

Taking a forward-looking approach, I believe that we live in an odd period where venture returns should structurally outperform stock market returns. In the last 70 to 80 years, the returns to institutional investors appeared to be about 6.5% real, and the return to corporations appeared to be about 7% real. What has happened over the last ten to 20 years, however, is that the corporate return of 7% has drifted up to roughly 10%. With global equities offering around 3.5% to 4.5% as an equilibrium return, and bonds yielding 0% real, a 60/40 traditional portfolio would be stretching to get to 3%. Any reasonable person would prefer 10% to 3%, so we are trying to get as close to corporate investing as possible.

A third argument for venture capital is the declining capital spending and experimentation from corporations. US and UK corporations have been aggressively buying back their own stock rather than pushing for higher market share. Corporate executives today are more conscious of their own profit margin maintenance, more risk averse, and hesitant to embark on new spending. From their perspective, buying their own stock comes with great career risk/return tradeoffs. Now if they're pulling back from capital spending, that decline is utterly enormous compared to the offsetting inflows of venture capital, which represent a rounding error. As a result, you can have what looks like a flood of money coming into the venture capital asset class, but corporations are pulling back multiples of that effect. The 3Ms of the world are not launching small and innovative endeavors like they used to. Multiply that phenomenon a thousand times across corporate America, and what you have is a shortage of funding for experimentation of new ideas. This dynamic should benefit venture capital investing, especially at the early stage.

This is a nice confluence of completely different ideas supporting the same general argument of favoring venture capital as part of a long-term strategy. And the final argument is that venture is widely considered to be a riskier asset class, and to put much into it is to take personal career risk, and therefore it's not unreasonable to think there would be associated higher returns. Cambridge's database seems to suggest that is exactly what happens.

For all these reasons, our Foundation is targeting a 40% long-term allocation to venture capital, and I'm not sure why we should even stop there.

> *"Our Foundation is targeting a 40% long-term allocation to venture capital, and I'm not sure why we should even stop there."*

RAVENEL: As of year-end 2015, our venture capital portfolio has generated a 19% IRR since its inception in 2006. Over the past five years it has returned 23%, outperforming the CA US Venture Capital benchmark of 16% over the same period.

How does your venture capital strategy align with the mission and impact goals of the Foundation?

GRANTHAM: Mission-driven investing fits into the picture beautifully because there are abundant opportunities in resource efficiency, alternative energy, and agriculture. There are hives of intellectual and entrepreneurial activity around these issues at universities and elsewhere. Still, I'd note that these are not "hot areas" because as we all know there was a wave of green investing that did rather badly a few years ago. Now, however, wind and solar are beginning to become competitive with traditional energy sources, region by region.

I've written in a recent GMO Quarterly Letter that some of these opportunities are so good from a mission perspective that if we were not making a capital investment we should have seriously considered making a grant from the program side instead. It's a perfect situation where these investments meet our mission every bit as much as our typical grant. They drive our mission forward, and we expect and certainly hope that one or two of them will make the Foundation a fortune, and give us a high return in an area which makes effective use of our dollars. That's why we have 20% of our total portfolio allocated to impact investments.

> *"Anytime there's an investment that could combine the socially desirable outcome with the rate of return potential, we would prefer it."*

What kinds of impact investments are you evaluating?

GRANTHAM: We are looking at areas such as a lithium ion battery chemistry with over twice the power-to-weight ratio and another lithium ion battery system that can charge in three and a half minutes. We are also evaluating an opportunity to invest in an ultra-light weight and ultra-streamlined electric vehicle that is incredibly energy efficient.

What about other impact areas outside of resource efficiency and the environment?

RAVENEL: We have an education technology–focused venture manager where the impact story there is not really core to our mission, but we committed because a talented investment team happens to focus on a growth sector that we believe in.

GRANTHAM: Anytime there's a venture capital investment that combines a socially desirable outcome with rate of return potential, we would prefer it. We know that diversification counts, and our first requirement is to do very well financially so that we have a pool that grows. We take returns seriously. Not seriously enough to buy tar sands and coal, but seriously. Our intention is to be the best-performing foundation in our size group.

RAVENEL: And if we could accomplish our impact goals in the process, all the better.

You mentioned tar sands and coal as hardline investment restrictions. What about oil companies given the recent dislocation in energy markets? What does the value investor in you think about potential opportunities in a beaten up asset class?

GRANTHAM: As we move away from oil as the primary transportation fuel, oil companies could pay a very high price. But I don't think that will happen in the next ten years, and in that time period the demand destruction on oil won't be enough to move the dial seriously, but after that it could be explosive. In the meantime there could still be a supply-driven imbalance from diminished exploration and relatively short-lived supplies of low-cost shale. And with continued demand driven by more drivers in China and India, we could see a dramatic increase in the price of oil in a five to ten year window.

RAVENEL: But since there are so many potential long-term disruptive forces for oil demand—climate policy and fuel efficiency regulations, substitution effects from ridesharing and electric cars—the question is when those disruptions become visible to the broader market.

GRANTHAM: We're buying 2020 oil futures now, because that window is about the longest we'll go without taking on material risk that demand destruction, real or perceived, will impact oil prices on the downside. In full disclosure, the Grantham Foundation no longer directly buys shares in oil companies, but we will still opportunistically buy oil futures to generate returns.

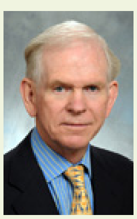
"Some opportunities are so good from a mission perspective that if we were not making a capital investment we would have seriously considered making a grant from the program side instead."

Why is this so personally important to you?

GRANTHAM: Collectively looking after our natural inheritance—water, soil, air—is important. We're running it down, quite probably reducing the "book value" of natural assets by the 3% to 3.5% that global GDP is advancing. So this is going to be, I believe, the defining set of questions for the next many decades: How do we protect our natural assets? How do we adjust for true replacement? What are we leaving to our descendants? How are we going to feed them if we don't fix erosion, and water, and unstable weather? You can't have compound growth in a finite world.

We are in the race of our lives. While the negative trends of climate change are moving a lot more quickly than the bulls realize, technology is also progressing faster than the bears think. So we have to take the problems very seriously and put our best foot forward. ■

Read Liqian Ma's research report, "Risks and Opportunities From the Changing Climate," available online at www.cambridgeassociates.com.



Hear From Jeremy Grantham at Our Impact Investing Forum

Jeremy Grantham is the keynote dinner speaker at the Impact Investing Forum on the evening of Wednesday, September 28th at the Waldorf Astoria in Chicago. The forum begins on Wednesday afternoon with a special two-hour session focusing on the risks and opportunities from the changing climate. Thursday, September 29th will be a full day of engagement with thought leaders, including both full group sessions and break-out topics of interest.

During the event we will:

- *Explore innovative approaches to investing for impact*
- *Discuss the challenges related to climate change and the associated opportunities for impact investors*
- *Discuss topics such as private market innovations, effective community strategies, sustainable hard assets, and total portfolio integration*

In Search of Tax-Efficient Alpha

Why private investments offer unique benefits for families

BY KRISTA MATTHEWS

AS PRIVATE INVESTMENTS have continued to deliver substantial long-term outperformance over public equities, and talented managers have found attractive opportunities across a variety of strategies and sectors, investors who have committed higher allocations to private investments such as venture capital, private equity, and private real assets have found themselves among top-quartile performers over the long term.

In fact, Cambridge Associates' analysis reveals that the average family allocating 15% or more to private investments enjoyed 170 basis points in total portfolio outperformance over a family that committed 5% or less to these growth-driving investments over the ten-year period ending June 30, 2015. But with the average family client at Cambridge Associates allocating 9% to private investments, many have yet to cross "the 15% frontier" that CA advises clients to consider for long-term success.

Private clients that can accommodate the illiquidity of private investing should consider the many benefits that a meaningful allocation to these types of investments can provide, says Philip Walton, President of Cambridge Associates and Head of the Private Client Practice.

The Tax Benefit

To start, private investments offer tax-efficient alpha. "When managing taxable portfolios, we are constantly searching for ways to add significant value to the portfolio in a tax-efficient manner," he says. "Among actively managed investment options, private investments can offer significant tax benefits."

One such benefit from private investments, Walton explains, is the lower tax rate on long-term gains. "Since private investment returns are taxed mostly as long-term capital gains, they incur a substantially lower tax rate than other sources of return in the United States and some other countries," says Walton. For example, the current US federal tax rate on long-term capital gains and qualified dividends is 23.8%. Contrast that with a 43.4% rate for short-term capital gains and other ordinary income (including the 3.8% Medicare surtax for both). While some private strategies may produce more ordinary income and/or realize ordinary income or taxable gains earlier in the life cycle, they can still be tax efficient due to offsetting deductions and other considerations.

"When you invest in private investments, the probability that your gains will be long term is high," says Walton. "That probability can be much lower for actively managed public equities."

The deferral of taxes can be another benefit. Given the life cycles of most private investments, investors generally will not realize a taxable gain or other taxable income until the fund liquidates its underlying holdings—frequently five years or more after the investment is made. Actively managed public equities, on the other hand, are more likely to generate dividend income or realize gains sooner than private investments, yielding less tax deferral.

"Among actively managed investment options, private investments can offer significant tax benefits."

Some funds, such as venture capital funds, also make in-kind distributions, often distributing shares of stock in their underlying companies rather than cash proceeds. While investors can further defer realized gains by holding these stocks, Walton says Cambridge Associates generally advises investors to sell such distributions.

Private investments can also play a valuable role in the tax-efficient transfer of wealth to younger generations. "In the United States and elsewhere, the value of private investments can often be discounted for gift, estate, or inheritance tax purposes since the funds themselves and in many cases their underlying holdings are illiquid and not readily tradeable," explains Walton.

Aligning Interests

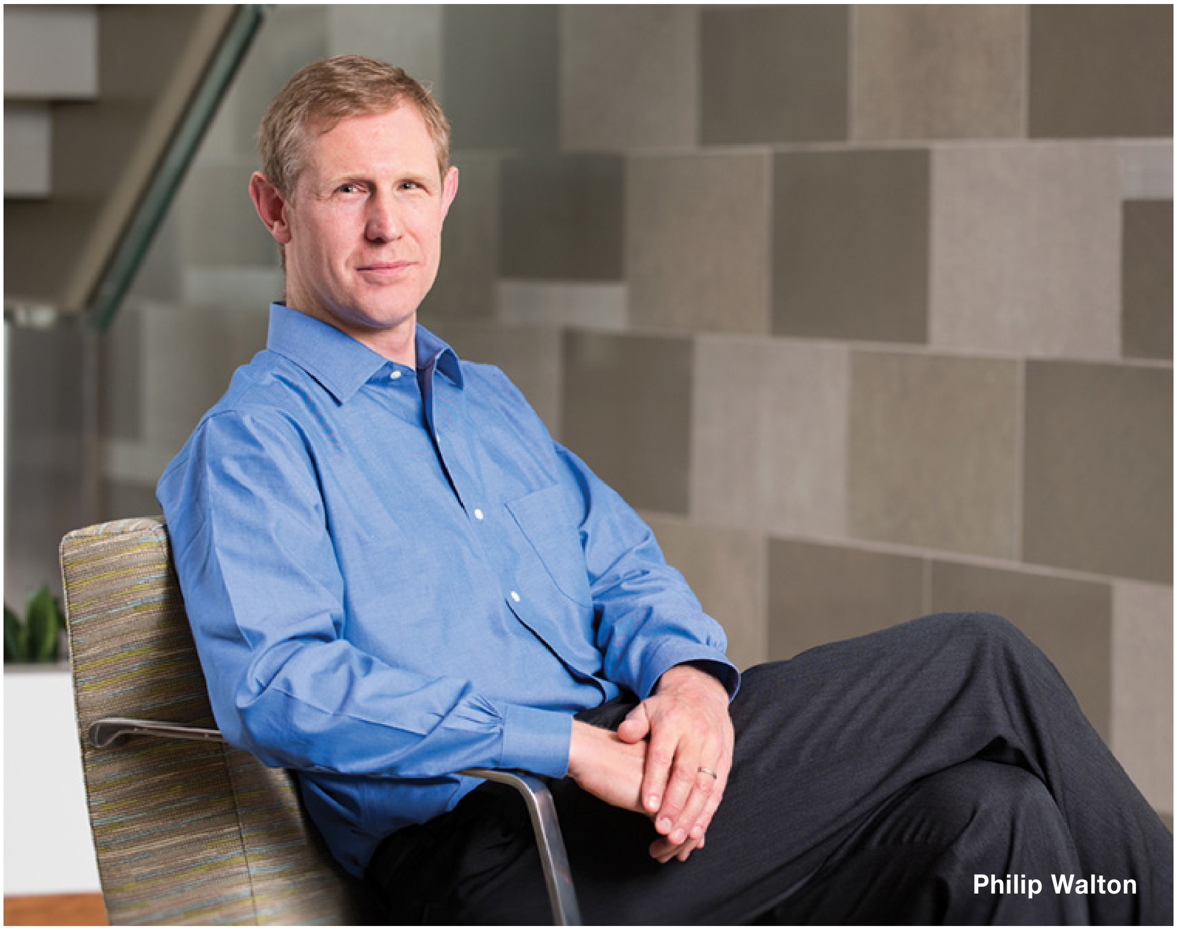
In addition to the tax benefits that private investments offer, many hallmarks of private investing align well with the goals and characteristics of family investors.

The long duration of private investments typically matches families' investment timeframe. "Private equity investors need to be comfortable with illiquidity," says Walton. "Families are usually focused on investing for future generations, so they can accept the trade-off that comes with

"When you invest in private investments, the probability that your gains will be long term is high. That probability can be much lower for actively managed public equities."

locking up assets to maximize their chances for long-term growth."

Family investment portfolios tend to have lower spending rates than institutional pools, bolstering their ability to accommodate illiquidity. Where an endowment might help support the overall operations of the enterprise, families have greater control on how and where they spend their assets. This gives them more flexibility to lock up a significant portion of their portfolio. "We work with families who have 30%, 40%, or even higher allocations to private investments," Walton says. "This has been instrumental to their strong performance over time."



Philip Walton

Families' governance structures can also play a role in implementing a successful private investment program. Families frequently have fewer decision makers than institutional investors, allowing them to act quickly when compelling opportunities arise. "Fund or co-investment opportunities often have short fuses," Walton explains. "Investors who can make decisions quickly and efficiently are better able to take advantage of these opportunities."

Some family investors have personal experience owning or running businesses, often giving them deep insight and interest in certain sectors. This expertise can help them better understand the complexities involved in private investing, which can help make them good partners for long-term investing. It can also aid them in making meaningful connections in the industry. "Some family members have been successful at using their strategic knowledge and networks to gain access to compelling managers that are closed to most new investors," says Walton.

"Families are usually focused on investing for future generations, so they can accept the trade-off that comes with locking up assets to maximize their chances for long-term growth."

Relevant strategy or sector expertise has also prompted some families to directly invest in a company as opposed to investing into a fund. "For clients with sufficient scale and resources, direct investments can allow families to tailor a portfolio, reduce fees, and generate higher returns," Walton explains.

This trend has led Cambridge Associates to assess co-investment deal flow and advise clients on how to consider and build direct investment exposure alongside a fund portfolio. Co-investment opportunities range from early-stage venture to buyouts, real assets, and private credit.

Private investments also offer families the opportunity to align their portfolios more closely with their personal values. As ESG (environmental, social, and governance) and other impact investing strategies have evolved from basic exclusionary screens to investments designed to proactively address social, environmental, and other goals, many families are finding an increasing number of attractive impact opportunities in the private markets. Walton connects this trend particularly to younger generations who have been actively engaged in environmental, social, and other issues. Many families have turned to private investments that focus on sustainability, infrastructure, technology, conservation, or renewable energy as a way to seek attractive returns from both a financial and a social perspective.

"Families are finding that their investment and philanthropic goals don't just co-exist, but can complement each other for maximum benefit," Walton says. To stay ahead of this growing trend, Walton notes that Cambridge Associates has a dedicated team focusing on impact and mission-related investments. This group currently tracks nearly 300 private investment impact and mission-related managers to help clients find the best ideas in this growing investment area.

"Private investments have been a driver of performance for investors that have a long-term view and access to resources that can find and implement the best manager ideas," Walton says. "In families' ongoing search for return, the potential tax benefits and alignment with investment objectives that private investments offer may be the icing on the proverbial cake." ■

NEWSLETTER PUBLICATION

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