Private Investments and Structures - Answers

Reading 1

Q1.1–Q1.4

Audrey Lake, CFA, serves as chief investment officer of the Mid States University Management Company (MSUMC), which manages Mid States University's USD400 million endowment. MSUMC targets real annual spending of 4% to support the university's operations. Lake is considering material changes to the portfolio’s strategic asset allocation and has compiled the following information for a board meeting.

Asset class	Large university (>USD1,000 million) endowment allocations	MSUF current allocation
Public equity	25%	45%
Public debt	20%	30%
Cash	4%	4%
Private equity	33%	15%
Private debt	1%	0%
Private RE	5%	3%
Private infrastructure	5%	0%
Other assets	7%	3%

Lake first highlights that MSUMC has 75% of its portfolio allocated to traditional public market assets while the typical large endowment’s public market allocation is only 45%. Private market assets are just 18% of MSUMC’s portfolio, compared to 44% of large endowment portfolios. Lake argues that MSUMC should strive to reallocate its investments to better match the targets observed for large endowments.

One board member notes that MSUMC’s total allocation of 60% to equity investments is not far from the average large endowment’s equity allocation of 58%. Lake responds that MSUMC’s current private equity allocation is solely focused on buyout equity strategies. She mentions that MSUMC’s allocation to this type of strategy is similar to that of large endowments. However, other endowments also invest in venture capital and growth equity strategies while MSUMC does not, forgoing exposure to startup and high-growth phase companies.

Another board member questions Lake about her strategy for allocating to venture capital investments because it will effectively be a new asset class for the endowment. Lake’s response focuses on a number of issues learned in working with buyout equity funds: (1) Identify VC general partners with top-quartile return histories, build relationships, and commit capital as opportunities develop; (2) have a well-defined plan for investing committed funds in liquid equities from industries similar to those of VC investments while awaiting capital calls; (3) accept the realities associated with lagged performance feedback from the fund; and (4) plan ahead in order to bear the illiquidity risk associated with the 7- to 10-year holding period of the fund.

The final question posed relates to the proposed roles for smaller asset classes, such as private debt. Lake mentions opportunities to improve returns from the debt portion of the portfolio by reallocating up to 5% from the public debt allocation. Specifically, Lake mentions the ability to invest in senior floating-rate notes as one way to gain yield along with inflation protection while ensuring high degrees of capital preservation from that portion of the portfolio.

Question 1.1

Discuss why Lake believes that MSUMC should reallocate such that its portfolio is weighted more toward private market investments.

MODEL ANSWER / EXPLANATION

Private market investments typically are expected to earn higher rates of return than their public market counterparts. Lake believes that the endowment, as a portfolio with a perpetual time horizon, is in a position to incur the higher risks posed by private market investments, such as illiquidity, as long as these extra risks generate sufficient additional returns to support the spending needs of the university.

SCORING RUBRIC

2 points for discussing Lake's rationale for the reallocation of MSUMC's portfolio

Question 1.2

Contrast how the features of the MSUMC endowment portfolio likely differ from those of large endowments with a focus on risk and diversification.

MODEL ANSWER / EXPLANATION

With respect to risk differences, MSUMC's total equity portfolio is likely less risky compared to a large endowment portfolio. While both MSUMC and large endowments invest similar percentages of their overall portfolios in equities, MSUMC's equity portfolio is more heavily weighted toward public equities compared to those of large endowments. As a result, MSUMC has less exposure to riskier equity assets in private equity, especially given its lack of exposure to startup company equity.

With respect to diversification differences, as mentioned for the risk differences, MSUMC may be lacking equity diversification across company life cycles in its equity portfolio. Additionally, MSUMC is more heavily weighted in public debt securities relative to large endowments that spread the non-equity portion of their portfolio across not only public but also private debt, as well as private real estate and infrastructure.

SCORING RUBRIC

2 points for contrasting MSUMC's portfolio with those of other large endowments in terms of risk

2 points for contrasting MSUMC's portfolio with those of other large endowments in terms of diversification

Question 1.3

Evaluate Lake's plan to invest VC committed capital in public equities from industries similar to those included in VC investments.

MODEL ANSWER / EXPLANATION

Lake is seeking to create a liquid portfolio with risk to that of the eventual VC investment by matching its industry exposure to target a similar return during the capital commitment period. Favorable market conditions may create more investment opportunities for the GP to call capital, and these may coincide with favorable returns on Lake's liquid equity portfolio. However, less favorable market conditions may cause declines in the value of this liquid portfolio during the time lag between capital commitment and call, thus creating a risk of being unable to meet a capital call in an extreme market downturn.

SCORING RUBRIC

3 points for commenting on the success of Lake's plan under different market conditions

Question 1.4

Identify and discuss a spending-related reason why Lake may be attracted to investing 5% of the endowment's portfolio in private debt.

MODEL ANSWER / EXPLANATION

Private debt investments typically provide higher expected returns compared to those usually available in public debt investments and may provide inflation protection to assist MSUMC in its annual spending needs. MSUMC's spending needs are at a real rate of 4%, so the endowment's annual nominal spending reflects the effects of inflation. The discussion of private debt specifically mentions investing in floating-rate notes that provide potential for inflation protection.

SCORING RUBRIC

3 points for explaining Lake's rationale for investing 5% of the endowment portfolio in private debt