Private Investments and Structures - Questions

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.

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.

Question 1.3

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

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.