Family Capital

VIEWPOINT

The next big thing in private markets – professional governance

By **Bev Durston** 19th May 2021

Great returns, low volatility, downside protection. What could possibly go wrong? Lots, it turns out, if you're not prepared.

In the days when private market investing was the domain of a relatively small group of well-connected individuals and firms, personal connections ensured that things ran mostly smoothly.

But as a more diverse group of investors seek these diversifying returns, funds must juggle their different interests. Professional governance is really important to get right in private market investing.

A clear sign of that is regulators flexing their muscles. In the US, the SEC is keen to see investment opportunities and expenses allocated fairly between investors in private funds, while in the UK, the FCA, having set governance rules for hedge funds, is now turning its attention to private investing.

Even the sexiest investments will suffer if you don't look after the un-glamorous bits

What do you need to be careful of?

Co-investment, for one thing. A big draw to private investing is the chance to co-invest with the manager on the juiciest deals. This can bring extra insight into the manager's sourcing and selection processes and access to lucrative deals that may, for various reasons, not fit into the main fund. Often there is a fee advantage too: co-investments typically offer lower fees.

Co-investing can certainly enhance your performance, but you may have to dig and cajole to be shown the best deals and avoid being fobbed off with other investors' left-overs. This demands both savvy and negotiating clout – especially if you want to co-invest directly, rather than via a co-investment fund.

Investors increasingly expect to see high standards in ESG policies and procedures. Indeed, recent UK Department of Work and Pensions regulation requires pension schemes to have a policy on financially environmental, social and governance factors.

Managers need to outline their policy on stewardship, including how they engage with investee firms and exercise voting rights. But it is still up to investors to challenge unrealistic policies and practices and to check that their manager is actually doing what they say they do.

Co-investment and ESG are the hot topics in this alluring, private markets universe. But even the sexiest investments will suffer if you don't look after the un-glamorous bits. You, or someone you trust has to do some cold, hard due diligence, both on the super-structure of how the manager makes and manages investments, but also the plumbing in the back office.

Do draw-down and distribution forecasts conceal leverage or other liabilities? Is the firm over-reliant on one or two key individuals? How much will you know about the LPAC and what it decides? Plenty of traps for the unwary: there is no substitute for a warts-and-all rundown of what could go wrong. And once you've made your investment, how is the fund being run?

Spotting great investments is the fun bit. Making sure the fund keeps humming along afterwards takes a different set of skills and even a different mind-set. How does the manager monitor the fund's investments? How often is progress reported and who monitors this for you? How do they spot new risks? Is the fund's administration being managed independently?

A particular difficulty for private funds can be how the fund is valued. While independent values of listed assets are easily observed, for unlisted assets it is much trickier – and sometimes not even entirely feasible. Many managers use counterparty valuations whilst others implement their own models and internal judgement. Both can be biased and this impacts fees. You need to be sure that the fund is valued as objectively as possible, especially if it inflates fee calculations.

That is not the only thing that can go wrong with fee calculations, which can be complicated and opaque. Catch-ups and high-water marks can be confusing, leaving investors paying more than they agreed to. Someone needs to do the hard yards to make sure that the agreed formula is being used as it was intended.

Look beyond the blurb and seek an experienced professional's perspective

To get the best out of any great opportunity you need to look beyond the marketing blurbs, examine the superstructure and inspect the plumbing. Make sure you are seeing the best co-investment opportunities, the fund is valued objectively, the fees you are paying are the right ones and the manager is doing what they say on ESG.

As with any important investment, a professional at your side is often money well-spent, either by investing through an intermediary or by engaging an independent advisor.

Private investing is a great opportunity to share in the fastest-growing parts of the economy – and to do good even as you reap the benefits.

This is best completed with the perspective of an experienced professional: take a cool, calculating look at what you're buying into; peer under the rugs; inspect the plumbing; pull the numbers apart and confidently share in the best that private markets have to offer.

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