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In today's challenging market environment, investors continue to seek ways to secure incremental return while balancing other portfolio and organizational demands. In this Q&A, Cambridge Associates discusses how it views and approaches private investments and other sources of incremental alpha in the context of its clients' total portfolio goals.

Sheila Ryan, Cambridge Associates

Sona Menon, Cambridge Associates

CAPITALIZE FOR KIDS: How does Cambridge Associates assist clients with their investment goals?

SONA: As a global, independent investment firm and advisor to more than 1,000 clients around the world, we design and manage investment portfolios to meet each client's expressed goals and circumstances. To do that, we apply a highly customized approach, meeting each client—whether a pension, private family, foundation or endowment—where they need us. That may involve advising on a portion of the portfolio (e.g., alternative assets) or overseeing a total portfolio under a variety of service models, including non-discretionary and fully discretionary. Regardless of the assignment, we apply our best ideas and resources in the way that makes most sense for each client.

CAPITALIZE FOR KIDS: What is the biggest challenge that investors face today?

SONA: A major concern is how to source sufficient return, especially within the context of each asset owner's organizational constraints and needs. The sustained low interest rate environment, coupled with increased volatility and challenged near-term outlook for equity returns, has created a difficult situation for all investors. Finding reliable sources of incremental return, while also meeting spending requirements or funding future liabilities, will be a tough balancing act for all.

CAPITALIZE FOR KIDS: What asset classes do you think will be key to addressing these challenges?

SONA: Each situation is unique, but in this low-growth environment, a simple stock and bond portfolio is unlikely to give investors the returns they need. In fact, given that many equities are fully valued and interest rates are at historical lows, never has there been a less desirable time to hold a simple stock-bond portfolio. In public equity markets, we still see valuation opportunities in areas such as emerging markets, natural resources equities, and Asia ex Japan equities, for instance. And a considerable potential for alpha generation continues to exist in a select group of alternative investments.

SHEILA: Among alternatives, private investments offer particular promise. If sourced and managed properly, private investments can be expected to deliver net returns in the low-to-mid teens, depending on the risk profile of the client.

We recently published an article that illustrated how clients with portfolios of at least 15% allocated to private investments outperformed those with lower allocations. These results were not just a function of superior returns over the most recent five or ten years. Over a full 20-year period, the median return for institutions allocating more than 15% to privates outperformed the median for the group with less than 5% by a cumulative margin of 182 percentage points[1]. Given this remarkably consistent pattern of outperformance, we believe investors concerned with the return outlook should look closely at private investments as a source of incremental return.

Of course, investors need to factor in liquidity concerns as they consider private investments, which are long term and illiquid. Every institution needs to be certain that the liquidity in its portfolio is adequate for likely cash flow needs. But many investors—even pension plans with substantial future accruals—place a value on liquidity that exceeds their true requirements, and thus miss an important opportunity to add value. Even in those cases where liquidity is a concern, a modest increase in the allocation to private investments can help close the gap left by other more liquid options.

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CAPITALIZE FOR KIDS: What areas of private investment do you view as more attractive today?

SHEILA: There are several pockets of value in the private investment landscape. One area that we think offers attractive risk/return characteristics is private credit, which covers a range of strategies including direct lending, structured credit, royalties, leasing, and other opportunistic strategies. Changes in the regulatory framework impacting banks and investment banks have resulted in significant growth in non-bank offerings in the private credit arena. Investors can earn high single-digit to low-teens returns through debt instruments, often with collateral and covenant protections. We think this is attractive, particularly in light of the alternatives available in the market.

Another area we consider attractive is the growth-equity segment, where high-growth companies are funded with equity to support their development. These strategies utilize little to no leverage, which combined with the high growth rates of the top-line business serves to provide downside protection. Growth equity returns historically have been similar to buyouts, but with lower realized loss rates.

We have also found that attractive returns are available in the lower end of the middle market buyout segment. This end of the market is highly fragmented. Skilled managers with the ability to source transactions and institutionalize small businesses can experience meaningful EBITDA growth, which they can in turn use to sell the business to a strategic partner or larger buyout firm.

In real estate, there is a large differential between the valuations of core assets and non-core assets. Strategies involving the purchase of non-core assets, with a plan to improve the physical characteristics and occupancy rate in order to position the asset for a core buyer, can result in attractive returns.

CAPITALIZE FOR KIDS: How does Cambridge Associates implement private investments?

[1] **"The 15% Frontier," Cambridge Associates Research Report, 2016.**

SONA: At Cambridge Associates, when possible, we prefer to build a program of direct relationships versus a fund-of-funds approach, and we construct portfolios in a highly customized, bottom-up way. We provide guidance and implementation by addressing four key considerations from the start.

First, we assess liquidity and other client-specific requirements, determining the role the investment pool plays given the investor's total portfolio and policies. Second, we establish governance and decision-making parameters, and ensure the existing decision-making group has flexibility and expertise. Third, we identify high-quality investment managers that represent a fit with the client's program. Lastly, we advise patience as we actively monitor the program's development. It can take anywhere from five to ten years to build a meaningful private investments allocation—and longer to fully realize benefits of the returns.

We have been able to help build successful private investment programs, working in various capacities with clients from non-discretionary to outsourced models and everything in between. In each scenario, the key is to thoughtfully invest, utilizing a combination of primary funds, secondaries, and co-investment opportunities.

CAPITALIZE FOR KIDS: What words of caution should investors considering private investments keep in mind?

SHEILA: Besides the illiquidity issue we discussed earlier, manager selection is a key consideration when constructing a private investment program. The ability to source, underwrite, conduct due diligence, and access a set of high-quality managers will determine a program's success. The dispersion of returns between above-median and below-median managers is material in private investments. Consistently accessing managers that have generated above-median performance has the potential to add several hundred basis points of performance. As a result, investors need to have sufficient resources and expertise to source, evaluate, and access high-quality managers.

SONA: Sheila raises an important point. In addition, any investment decision, including a commitment to private investing, must fit each investor's unique needs and circumstances. As advisors, our job is to look across asset classes and opportunities to identify the best pockets of value and incremental return that suit each client. In that context, it's critical to take into account the entire portfolio to make sure that every element works together—and better—as part of the whole. This includes weighing if and how private investments may be appropriate for a given investor.

That said, while private investments may not be right in all cases, one real risk lies in thinking that an institution's relatively small size prohibits successful participation in the space. The belief that privates are only for very large institutional investors is unfortunately a common misperception. It is true that an investor with a total portfolio of less than $250 million, for instance, might be precluded from some opportunities requiring large commitments, or might not have the in-house resources to manage such a program. But the benefits of allocations to privates still exist and can be realized at smaller asset levels—and they often are well worth the effort, if executed well.