Institutional Investors Survey

2018 Annual

PitchBook

Contents

Check out the accompanying data pack for additional charts and data points not included in the PDF.

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Executive summary

Virtually every LP type has been aggressively upping its allocation to private market strategies in recent years. The common rationale is that in the low-yield environment that has persisted since the global financial crisis (GFC), investors have turned to private market managers for growth and superior returns. That is one factor, but a broader sea change is underway as institutional investors continue to reassess portfolio construction and external manager compensation.

In public markets, the debate has been between passive and active management, with the former seemingly having won the day for the time being as alpha has become more difficult to generate while investors prioritize cost savings and convenience. While active management tends to be inherent to private market strategies, a similar mindset has permeated the space with private market investors applying pressure on GPs to lower fees and provide greater transparency.

Even with these efforts, private market strategies remain relatively expensive; however, it is often easier to rationalize the extra effort and cost associated with private market strategies, as opposed to advocating for an active public markets strategy, because the investment opportunities are inherently idiosyncratic and cannot be easily mirrored with low-cost index funds. After several years, the trend of increasing allocations to private markets remains intact—but it is showing signs of waning.

To better understand how private market investors are positioning themselves for 2019 and the years ahead, we conducted a survey of more than 50 allocators of capital ranging from sovereign wealth funds and public pensions to family offices and HNWIs.

Key takeaways

- LPs expect to **increase their private markets allocation from 30.9% to 32.5%,** on average, over the next 24 months.
- **Greater than 30% of respondents have lowered their return expectations** for buyout, growth, VC and real assets funds.
- **Fees are under pressure;** they were viewed as the most important factor when making a fund commitment, as well as the area with the worst alignment with GPs.

Allocations

Volatility has struck public equity markets as we near the end of 2018, but survey respondents largely seem to be maintaining course for the time being. Public equities and fixed income continue to represent the lion's share of most portfolios, and survey respondents largely expect to maintain their current allocation to fixed income over the next 24 months. Private market strategies have enjoyed a broad-based increase in their allocation and are expected to see their share of portfolios rise again in the coming years, with the average allocation expected to grow from 30.9% to 32.5%. While a relatively small shift, this capital is anticipated to come from hedge funds as LPs rejigger their mix of alternative investments.

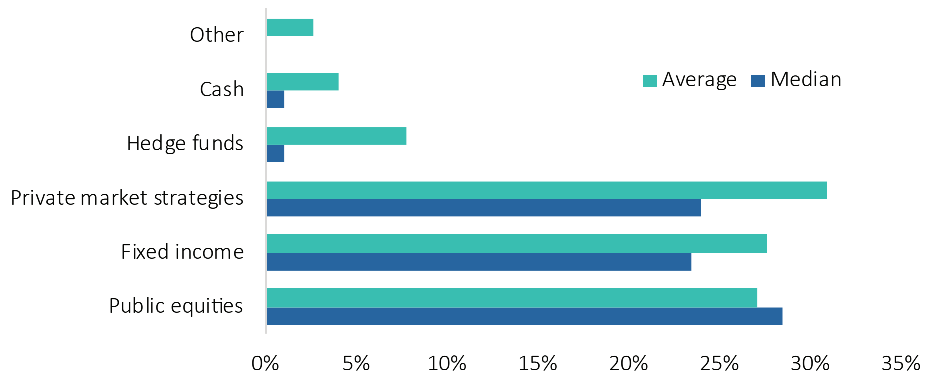
In terms of capital already committed to private market funds, most investors expect the pace of capital calls to at least be maintained in the year ahead across all private market strategies. Respondents anticipated the biggest spike in activity from private debt funds, which have enjoyed rising popularity in recent years. The extended slowdown in FoFs is expected to continue, as many investors turn to secondaries as an alternative means of accessing private market funds. Indeed, nearly 40% of respondents anticipate capital calls from secondaries funds—already hovering at record levels—to increase even further in 2019.

32.5%

average anticipated allocation to private markets in 2020

Private markets represent the largest portion of LP portfolios

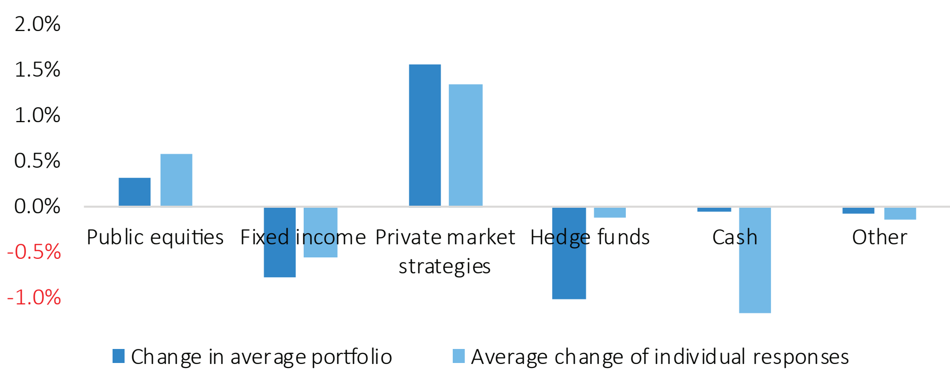
What is your current target allocation to the following asset classes or strategies?



Source: PitchBook
*As of December 2018

Private market allocations are primed to grow even larger

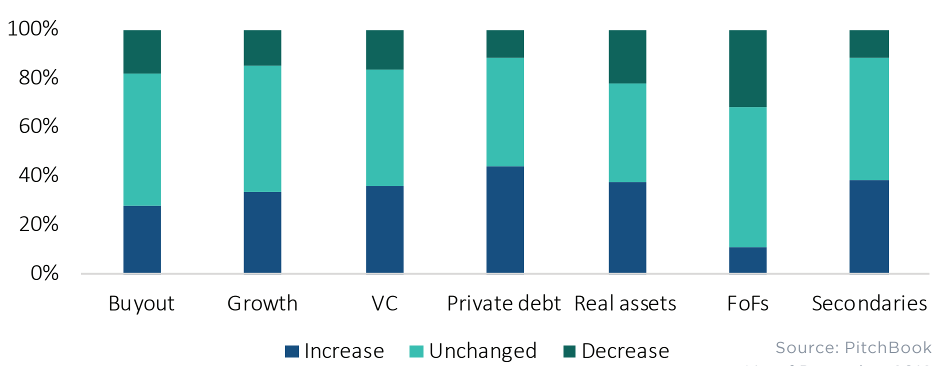
How do you anticipate your target allocation to the following asset classes or strategies changing in the next 24 months?



Source: PitchBook
*As of December 2018

Capital calls from private debt and secondaries funds expected to accelerate

How do you expect your pace of capital calls for the following private markets strategies to change over the next 12 months?



Source: PitchBook
*As of December 2018

ALLOCATIONS

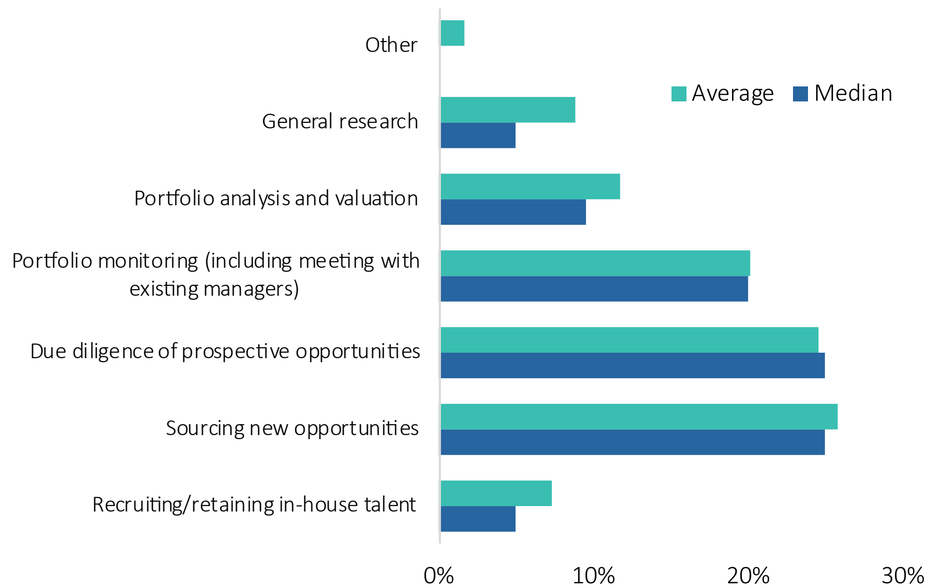
A day in the life

Certain LPs, such as endowments, have outsized allocations to alternative assets and private markets. But for most LPs, these spaces represent a fraction of their overall portfolio and are fundamentally different than public equity and fixed income—where most investors have the bulk of their allocation. As such, overseeing an alternatives portfolio is often a peripheral activity for many LPs.

Interestingly, when LPs dedicate time to alternatives, they spend little time conducting general research or analyzing their portfolios. Instead, roughly three-quarters of their time is spent sourcing and conducting due diligence on managers, as well as monitoring existing ones. Unsurprisingly, the areas in which LPs spend the least time, such as general research and portfolio analysis, are also the ones that can or should be outsourced.

Investors spend most of their time managing their managers

When managing your alternatives portfolio, how do you spend your time as a proportion of your workday?



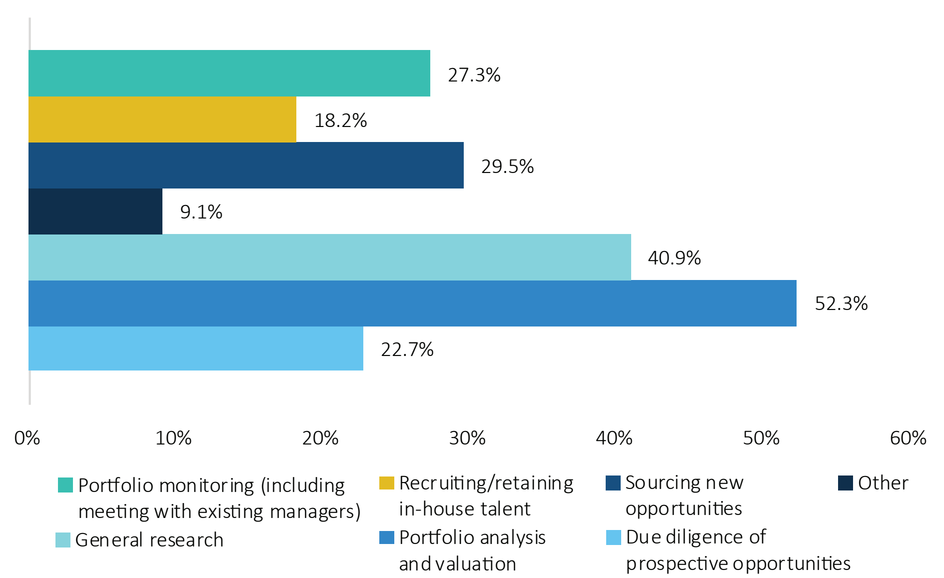
Source: PitchBook
*As of December 2018

13.7%

of respondents employ a discretionary advisor to oversee their private markets portfolio. Consultants and non-discretionary advisors were also used infrequently, with most LPs relying on an in-house team.

Investors want to keep most tasks in house

Which aspects of the investment process and/or portfolio management do you think can or should be outsourced? (Please select all that apply.)



Source: PitchBook
*As of December 2018

LP-GP relationships

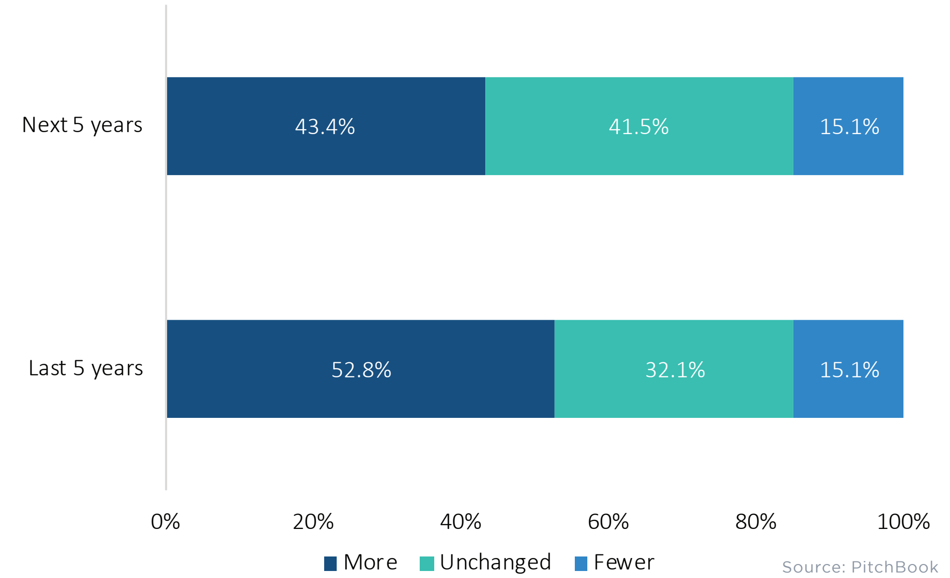
In recent years, the financial media has sowed the narrative that LPs are making a concerted effort to reduce the number of their manager relationships to establish better ties with GPs, streamline their investment operations and allocate larger sums with the best performers. Sales on the secondary market and high-profile efforts from LPs such as CalPERS provide anecdotal evidence to support that story, and while that may indeed be the case for some prominent LPs, our survey respondents paint a different picture.

More than one-third of respondents have more than 25 manager relationships, and more than half of them have seen their number of manager relationships increase over the last five years, while only 15.1% report a reduction. Even looking ahead, the vast majority of respondents expect to maintain or increase their GP relationships. One factor could be that our pool of respondents was skewed toward smaller LPs, namely family offices, many of which currently have relatively few manager relationships. This is particularly true for LPs branching into new areas of private markets, such as private debt and secondaries.

Despite ubiquitous warnings that past performance does not predict future results, the received wisdom is that LPs will start with assessing past performance when deciding to commit to a manager. It could be that respondents were hesitant to admit this tendency, but our survey indicates that past performance is in the middle of the pack of factors considered by LPs. When marketing themselves, private market managers tend to tout their culture, investment process and the quality of their people as differentiating factors; however, these factors were rated least important. Interestingly, respondents

Most investors have more GP relationships than five years ago

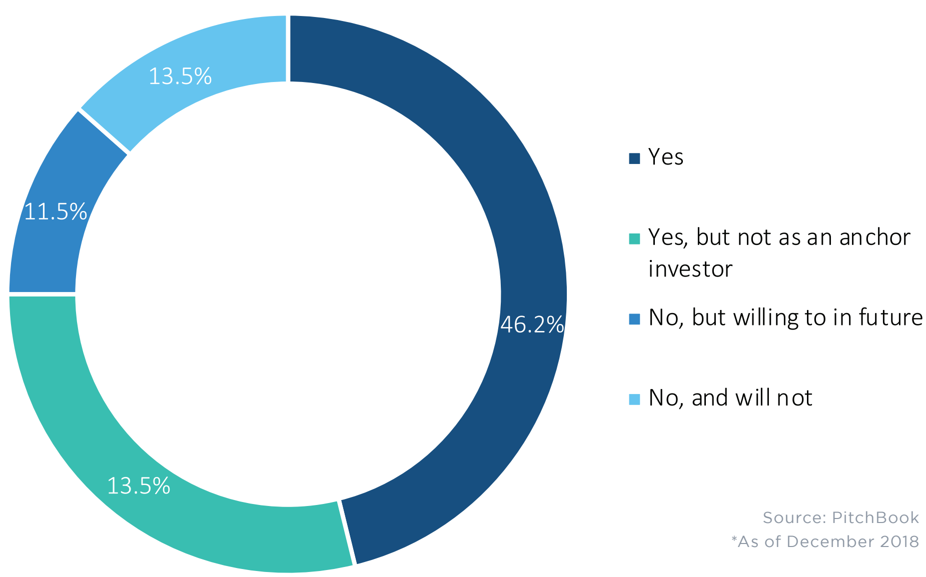
How has/do you expect your number of manager relationships to change(d) over the following periods?



Source: PitchBook
*As of December 2018

Investors are largely willing to consider first-time funds

Have you committed to a first-time fund?



Source: PitchBook
*As of December 2018

did place considerable weight on existing relationships with managers, seeming to indicate that personal ties may be the most crucial qualitative factor for a GP.

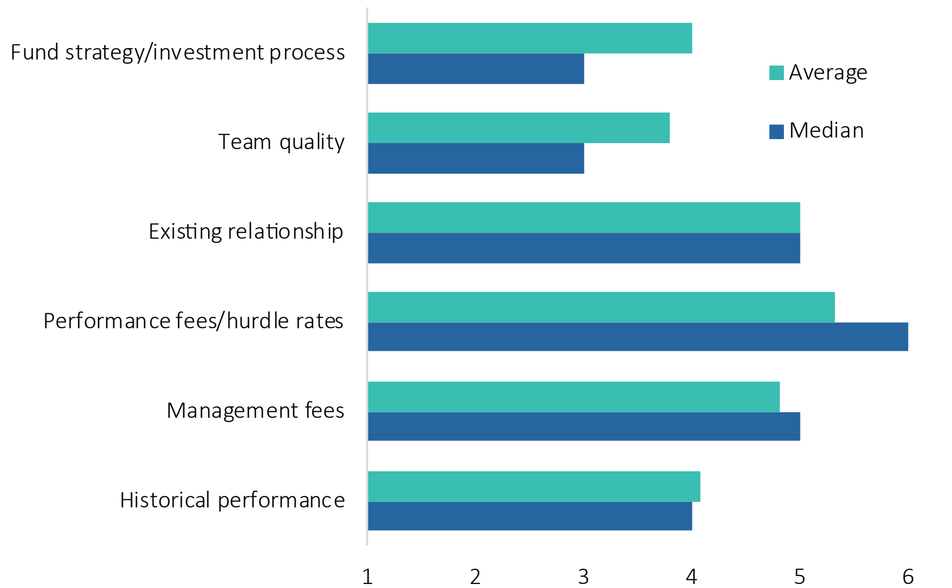
Like many public market investors today, cost is the biggest concern for private market LPs, with management and performance fees, respectively, ranking highest on the list. We expected LPs to place more importance on management fees, assuming they would cede more ground on performance fees that accrued in tandem with better returns. While both types of fees ranked similarly in this question, the differences become apparent when asking specifically about fee structure. When presented with the option of a lower management fee with higher carry or vice versa, 87.0% of respondents chose the former option. When we asked about aligning incentives with GPs, it was then unsurprising that respondents found fees as one of the areas with the most opportunity to improve alignment.

Regulators and industry participants alike have pushed for greater transparency in the industry, and LPs are reporting that they are now largely aligned with GPs in this regard, with only 9.8% seeing poor alignment. The two sides also seem to have found common ground on GPs' commitments to their own funds, but there is still room for alignment improvement regarding capital call facilities—which have been a hot button issue in recent years.

Fund timelines were another area in which respondents reported relatively poor alignment with GPs. Changing dynamics in private markets have spawned so-called long-dated funds that have more extended time horizons than traditional vehicles. But a known secret in private markets is that funds already tend to live long beyond the purported 10- to 12-year timeframe. That said, we were surprised to find that only half of respondents said they would commit capital to a fund for more than 12 years.

When selecting a manager, fees and relationships trump performance

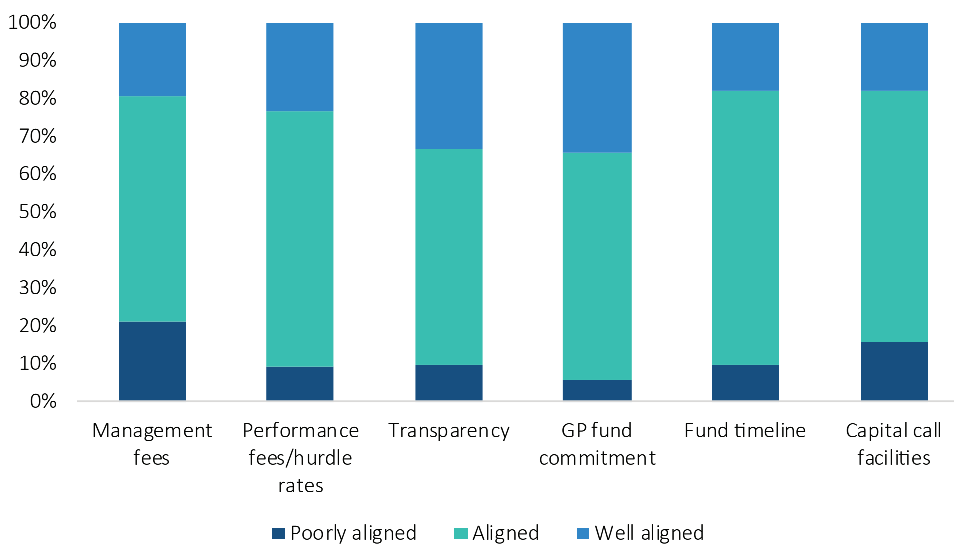
When considering a fund commitment, how important are the following factors? (Please rank with 1 as least important and 6 as most important.)



Source: PitchBook
*As of December 2018

Managers still have room to improve incentive alignment

How well are you aligned with your GPs on the following terms and conditions?



Source: PitchBook
*As of December 2018

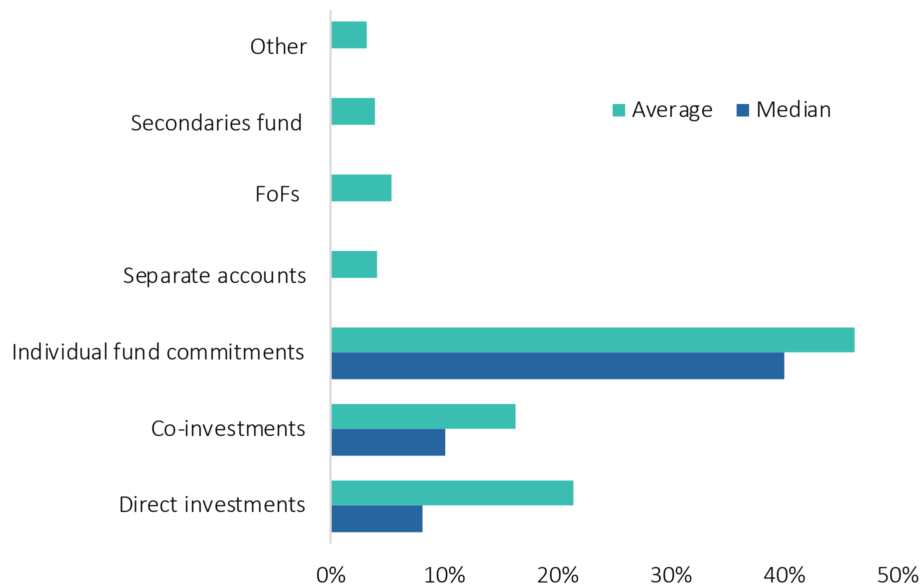
Access points

Individual fund commitments are the most common way for LPs to access private markets, but they account for less than half of all capital allocated as investors exhibited a strong appetite for access points that get them closer to the underlying deal. To that end, direct investments and co-investments combined to account for nearly 40% of the average allocation to private markets. Even though FoFs have delivered weak performance and appeared to be the least-favored strategy in many questions, they still account for about 5% of the average allocation. But this average is largely the result of a few outsized allocations from respondents, as the median FoF allocation is 0%. Secondaries had the lowest allocation of any strategy on the list, but we expect this to change as FoFs continue to fall out of favor and the thesis behind secondaries continues to strengthen.

Few LPs in our survey employ the assistance of an advisor or consultant when allocating to private markets, with a plurality relying solely on their in-house team and 90% employing an in-house team in some capacity. We expect this to continue given the heightened focus on fees, as it is often easier to justify paying in-house personnel rather than adding a layer of fees by paying outside consultants. This trend should also engender more adoption of third-party networks and tools, which are currently used by 29.4% of respondents.

Fund commitments remain popular, but investors seek out more direct access

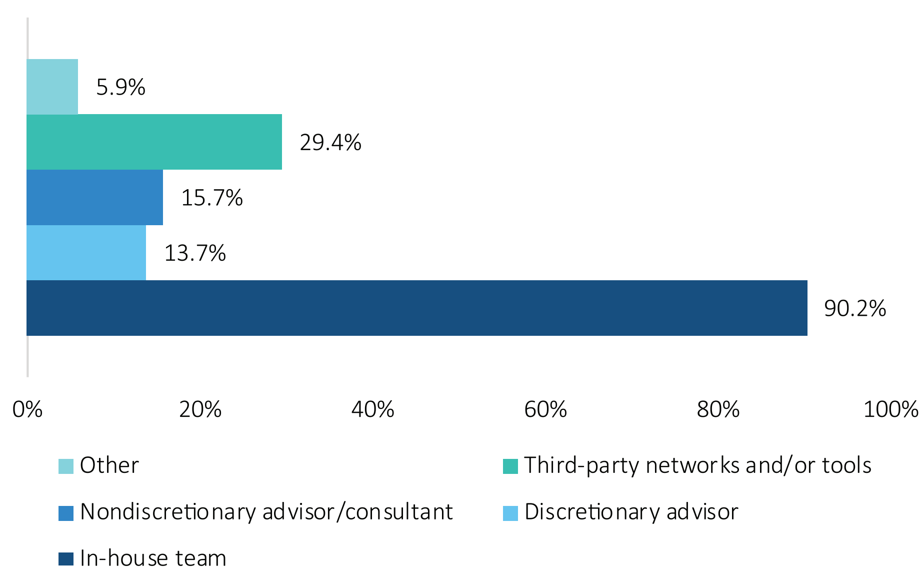
What percentage of your private markets allocation is committed through the following access points?



Source: PitchBook
*As of December 2018

Investors tend to rely heavily on their in-house team

How do you source managers or deals? (Please select all that apply.)



Source: PitchBook
*As of December 2018

PitchBook

Return expectations

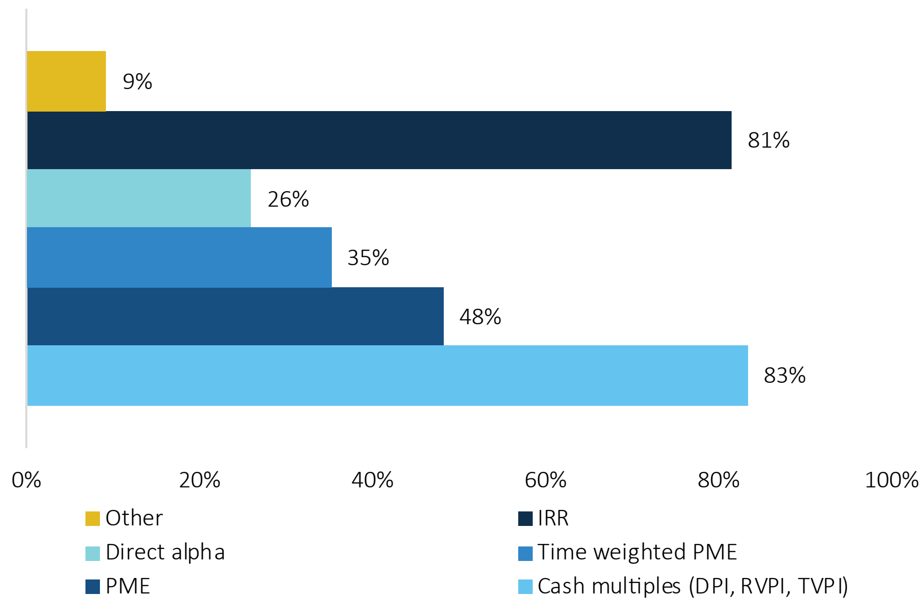
Despite its litany of flaws, IRR is a ubiquitous metric for assessing private market performance, so we were shocked when slightly more respondents reported using cash multiples. The margin was small to be sure—but this is a notable result nonetheless. With only a few exceptions, LPs utilized multiple return metrics to assess the performance of their private market investments. This approach is prudent, as no single metric can capture all of the nuance of a fund commitment. One of the best attempts to achieve this is PME. Most academic papers now feature PME for performance analyses, and the metric continues to slowly gain traction among practitioners, with 48.1% of respondents using it in some capacity.

Absolute returns for private market funds, which posted astronomical returns through the industry's first several decades, have been falling for several years as more money has poured into the space. Even for newer strategies, such as private debt and secondaries, there is increasing concern that returns are primed to fall as more investors join in.

Despite signs that the tide may be turning, LPs remain quite sanguine about the long-term prospects for private market strategies on an absolute basis. IRR expectations are in the double-digits for every strategy except for FoFs, which seem destined to evolve or die as a private market strategy. VC garnered the loftiest return expectations with respondents expecting an average IRR of 19.8%. While investors are correct to demand superior returns from VC funds due to their higher-risk profile, historical performance data suggests that most will fall well short of the watermark. Buyout and growth funds—both of which we categorize as PE—predictably had similar return expectations of 15%-16%, while private debt and real asset funds both came in slightly lower at about 11%.

Benchmarks still rely heavily on cash multiples and IRRs

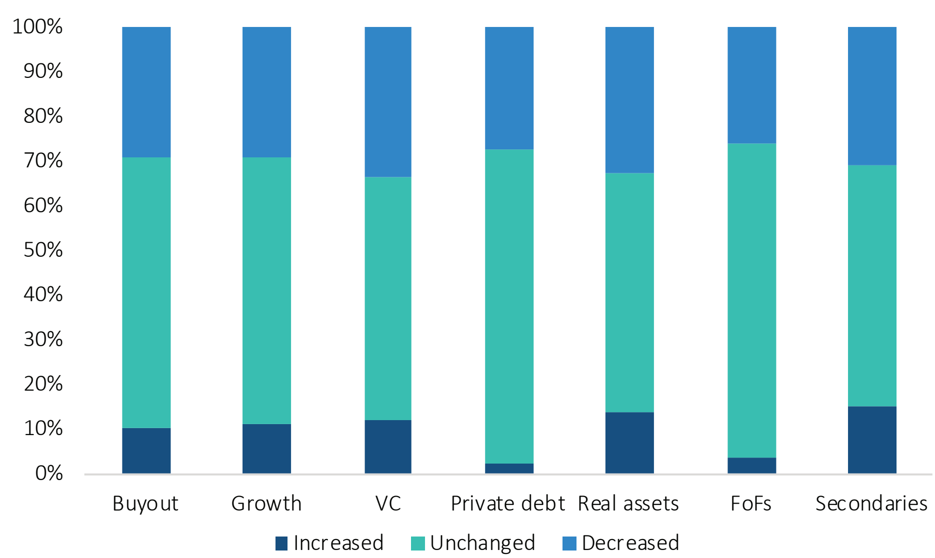
Which return metrics do you use to evaluate your private market investments? (Please select all that apply.)



Source: PitchBook
*As of December 2018

Return expectations are falling across private market strategies

How has your return expectation for the following strategies changed compared to this time last year?



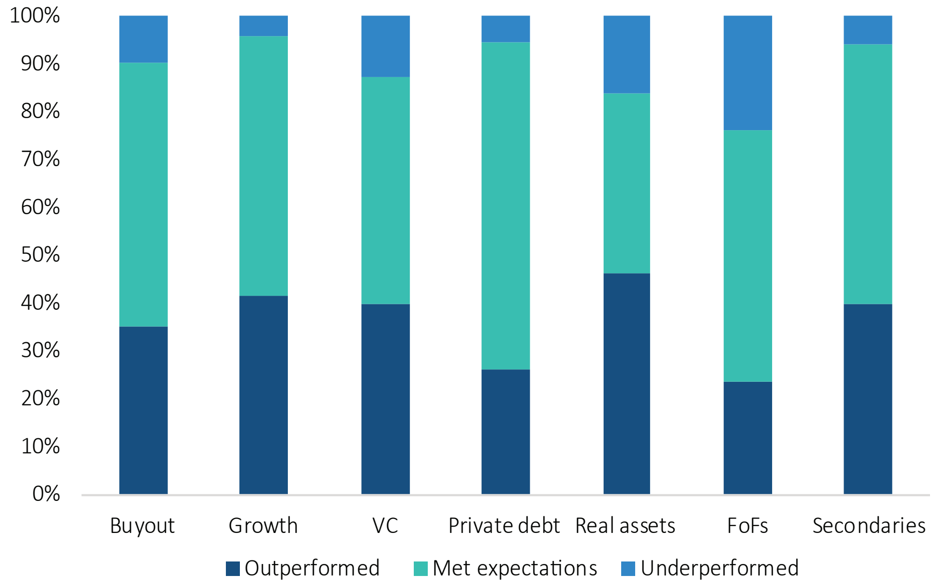
Source: PitchBook
*As of December 2018

Even with these high expectations, private market strategies have mostly continued to deliver. This was even the case for VC funds, which have struggled in aggregate historically but have performed well in recent years as capital has flooded the space and more companies opt to sustain their growth with cash from VCs rather than going public or being acquired. Given the long-term performance of the strategy, it seems unlikely that satisfaction with the asset class can be sustained—especially with the lofty, albeit falling, reported return expectations.

A similarly bearish case can be made for other private market strategies as well, and some LPs are beginning to brace themselves for this new reality. Over the last year, approximately 30% of respondents have lowered their return expectations to buyout, growth and real assets, while fewer than 15% have raised them. Investors were even more pessimistic about the prospects for private debt and secondaries.

Most private market strategies have met or exceeded expectations recently

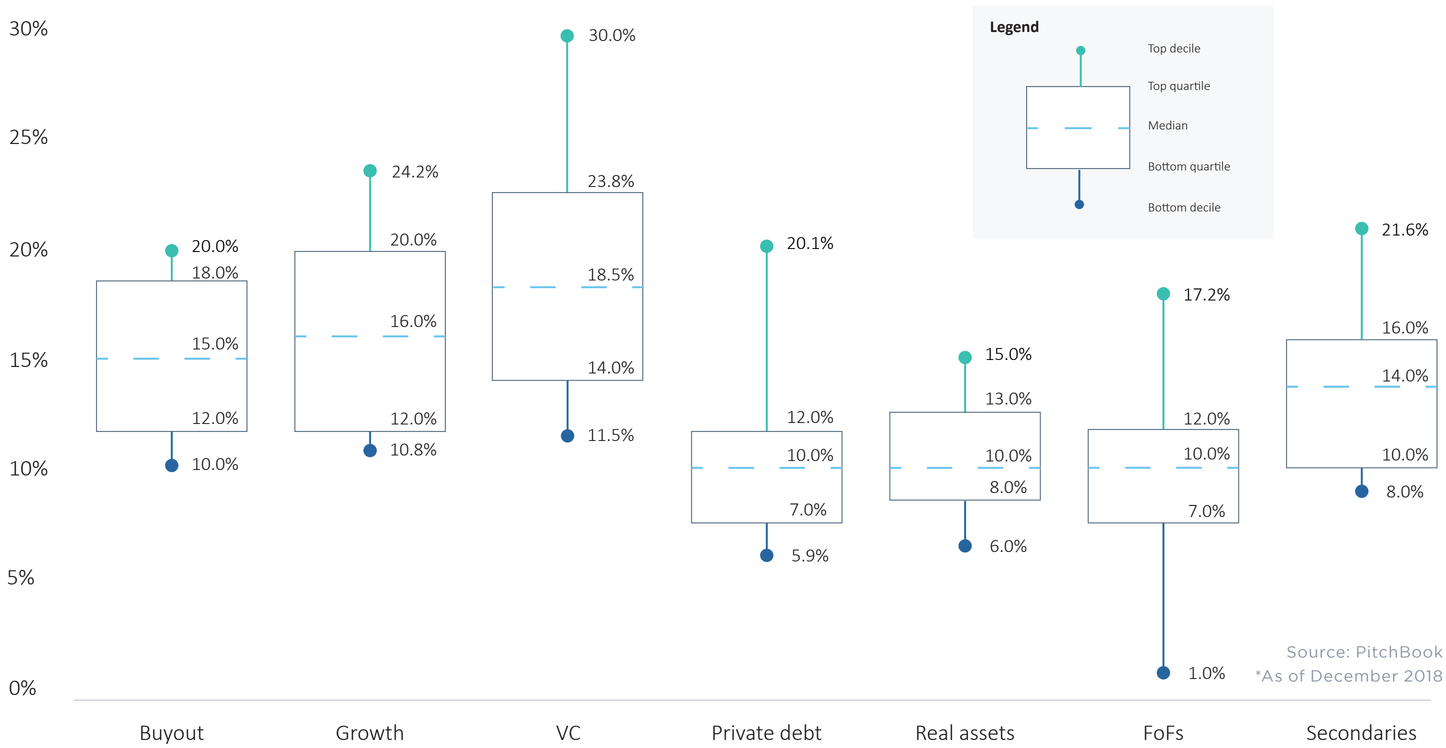
How have the following strategies performed over the last three years relative to your expectations?



Source: PitchBook
*As of December 2018

VC funds have the highest return expectations, despite long-term underperformance

What are your long-term return (IRR) expectations for private market strategies?

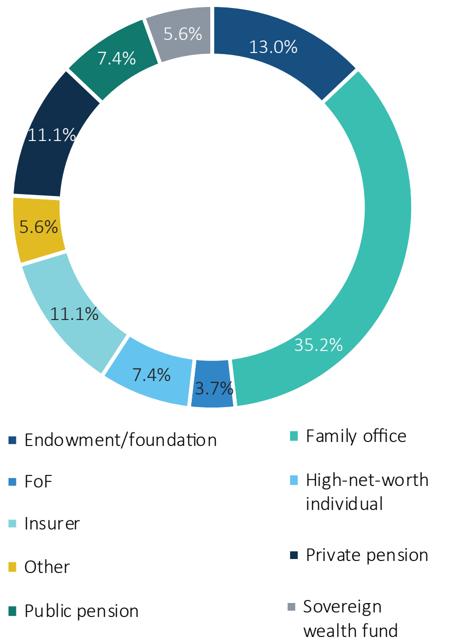


Source: PitchBook
*As of December 2018

Methodology

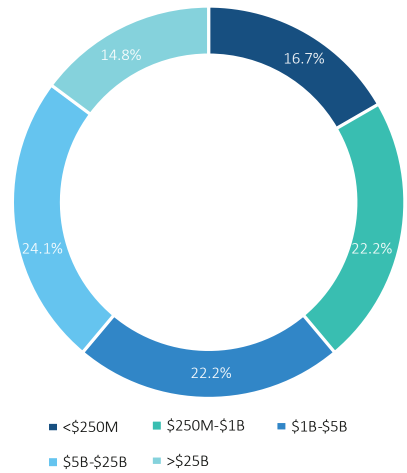
This survey includes responses from more than 50 global LPs. Some questions included an "N/A" option, which was excluded from any proportions reported in the analysis. If you would like to participate in the next edition of the survey, please reach out to reports@pitchbook.com.

Please indicate your firm type.



Source: PitchBook
*As of December 2018

Please indicate your firm's approximate AUM.



Source: PitchBook
*As of December 2018