Fiducient Advisors, Nonprofit Investment Stewards Podcast
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Nonprofits and Private Equity – with Matt Kaminski

[00:00:00] Welcome to Nonprofit Investment Stewards with Bob DiMeo and Devon Francis from Fiducient Advisors. Bob and Devon are passionate about helping nonprofit organizations prosper. Whether you oversee endowment, foundation or retirement plan investments, this podcast exists to help stewards improve performance, reduce costs and discover strategies that enable your charitable organization to prosper and advance its mission.

[00:00:26] Now onto the show. Hello, and welcome back to the Nonprofit Investment Stewards podcast. I'm Bob DiMeo. Great as always to be joined by co-host Devon Francis. As we begin this episode, the stock market as measured by the S&P 500, it sits near all-time highs and we already experienced more than 50 new highs in 2021 alone.

[00:00:52] So if you're overseeing an endowment or a foundation portfolio, you've got a pretty good-looking rear-view mirror right now with respect to [00:01:00] performance, but Devon and I, and frankly, many of our colleagues at Fiducient, we sense a growing concern from the investment committees we work with. And what's that concern?

[00:01:11] It's a concern for what returns might look like on a go-forward basis. So, some investors are attempting to navigate the challenge by investing in alternative investments like private equity. And PE is a staple in portfolios for many non-profits, but it's still only in the consideration stage for others.

[00:01:32] In today's episode, we're not only tackling the basics of private equity, we're going to glean insights on the current state of PE, including some of the opportunities and we are absolutely going to touch on some of the pitfalls in today's market. Devon, how's your day going? And what do you think about today's topic?

[00:01:50] Thanks Bob. I'm doing great. And I think it's such an important topic that we're covering today. I am thrilled to have Matt Kaminski with us. Matt directs our [00:02:00] firm's global private markets group, and he oversees investment research and due diligence efforts on the private side. He's also a member of the firm's investment committee, the research forum, and our discretionary committee.

[00:02:12] Matt is a CFA charter holder. And he serves on the finance and audit committee for Connecticut food share, which is a nonprofit anti-hunger organization in the greater Hartford area. I've been working alongside Matt in our Connecticut office for the past 12 years. And I will let you know that he is one of my favorite people at the firm.

[00:02:31] He is the perfect combination of incredibly smart while also being very down to earth and approachable. He is also a great dad. He has two young kids who keep him very busy, so we are so happy that he has carved some time out of his busy schedule to chat with us today. So Matt, welcome to the show. Thank you, Devon and Bob for having me.

[00:02:51] And Devon, thanks for such a kind introduction. I've appreciated all the time I've got to spend working alongside of you as well. Matt, we're thrilled to have you join us. And it’s [00:03:00] really the second time you and I are together today. We were working with another large client earlier today and appreciated your input there too.

[00:03:06] But why don't we start with your story, Matt? Tell us a little bit about how you ended up pursuing investments as a career and perhaps more specifically, how you became so passionate about private investments? Sure, no problem, Bob. So, I actually grew up as one of those sort of kids who was really into numbers.

[00:03:25] I loved math and I loved anything that had to do with numbers. And I wanted to pursue that actually as I went into college and was thinking about going into being a math major but actually had the foresight to think about what I would actually do in a career with math. And through some conversations with some family members, I opted for a degree in finance.

[00:03:46] So trying to take that, those interests in math, and put them towards something useful in the finance space. I've been with the firm for 12 years and I've conducted due diligence on essentially every type of strategy that our clients will come into contact [00:04:00] with before settling on private equity over the last few years.

[00:04:03] And I think what I like about the private markets is it's pretty intuitive to see that path towards value creation with the general partners that we invest in and in turn creating performance for our client portfolios. So, whether that's helping a venture capitalist who's funding an entrepreneur's next big idea, or investing in a buyout shop that's buying a successful small business and professionalizing it for its next stage of growth.

[00:04:22] It really makes sense to me how those investors were looking to drive returns within their portfolios. On the other hand in the public markets, we've seen managers do their work, take a position, but you're just alongside or along for the ride.

[00:04:40] While in private markets, excuse me, the general partners really have the ability to control their own destiny and that really resonated with me. So Matt, before we get into kind of the granular details of the private equity landscape, let's just level set. Can you share with listeners what we mean when we say alternative investments, broadly speaking? [00:05:00]

[00:05:00] And then specifically, what do we mean by the term private equity? Sure Devon. So, I would define alternative investments as really any investments outside of the market exposures that we gained through traditional stocks, bonds, and cash. So those are typically the building blocks we see in client portfolios, really of all types.

[00:05:19] But outside of that space, we think of hedge funds. We think of real assets. And then we think of private assets as really what we would define to be alternative investments. Private assets, as I mentioned, would include private credit, potentially private real estate, and obviously private equity, which is what we're going to speak about today.

[00:05:38] So within the private equity space, what are some of the different types of strategies and maybe some of the characteristics of each type of strategy? Absolutely. And it's a great question because private equity is such a big umbrella. We generally define the strategies by company stage, and I would say for this conversation, it makes sense to really hit on two main areas.

[00:05:57] First, I'd start with venture [00:06:00] capital. So, this involves generally smaller investments and what we call seed stage companies. So, this is typically, a general partner would be out backing an entrepreneur or an idea. Uh, it's often before a product has even been established or definitely before revenue is being generated.

[00:06:17] So these are minority non-control investments in these really early, early formative stage companies. The investments from the venture capitalists are to help the businesses scale, up the entrepreneurs, further build out their ideas. It can often involve multiple rounds of capital as those businesses start to, uh, to get off the ground.

[00:06:37] Venture capital is generally thought of as higher risk, but higher reward portion of the private markets. We often see companies in this space fail. A lot of times, uh, even great entrepreneurs have ideas that don't get off the ground, but this is really the space where you see funding for some of the most widely known tech companies that we see in the headlines today.

[00:06:56] Some household names that come to mind for me in the venture capital [00:07:00] space would be groups like Sequoia, Excel Partners, Andreessen Horowitz. Many of those names have been behind many of the most successful technology act yields of the past decade. And they're most widely known names in the venture space.

[00:07:14] On the other end of the spectrum I would say is the buyout space. This is when general partners buy majority stakes. So controlled positions in mature businesses with the goal of executing some type of operational improvements to add value to those businesses before ultimately looking to solve them. The umbrella of buyout is also a big one.

[00:07:34] So this can involve simple purchases of small businesses. This can be corporate carve-outs or at the large end of the market, the exercise of taking public companies back to private for a reason, or one reason or another. The risk and reward in this space is different. And I would say overall lower, just given the maturity of the businesses that are often involved.

[00:07:54] And the ability to generate returns, as I described in my opening remarks, is just more contingent upon the general [00:08:00] partner's ability to add value to the businesses that they're buying by either increasing growth or cutting costs. And then, you know, to read between the lines of those two sort of main areas, there are other iterations such as growth equity, which would be in between venture capital and buyout where growth capital is provided to businesses that have, I would say, reached a critical mass and are established.

[00:08:24] Or other areas like special situations or distressed investing, which is similar to buyout, but actually investing in companies where there's some type of distress situation and actual turnarounds are needed to save the business.

[00:08:36] So to answer your question, Devon, that's the spectrum that we think of when we're looking at the opportunity set in private equity. Thanks, Matt. It's funny. When we begin a relationship with a new client, if I'm working with that client, I'll often say, listen, if you're a charitable organization, if you could achieve your goals, your organizational goals, advance your mission by investing in US [00:09:00] treasury bills, you should, and people will chuck a little bit, but I say, no, really you're not an investment entity or a hospital university.

[00:09:08] Religious order, whatever the case may be. If you truly could achieve your goals investing in the safest, most liquid asset class in the world, why wouldn't you? Of course, most institutions can't. So, then they have to begin investing in riskier, higher return seeking investments. But with that said, we don't roll out of bed saying, hey, let's own more complicated investments, maybe more expensive investments.

[00:09:33] So perhaps you could, it's a long way of me asking, perhaps you can touch on why a nonprofit organization would even want to consider adding private equity to their portfolio and touch a bit on the upside to that. Absolutely. Bob. I think you hit on one of the key challenges facing a lot of our clients today, which is the overall return environment in our capital market assumptions going forward, which clearly are lower than what they'd been in the past.

[00:09:59] It's funny you give the [00:10:00] example of treasury bills. There's a chance that some 30 years ago that some of our clients could have achieved their mission and their objective simply doing what you just said. And that's clearly not the case today, and won't be the case going forward we believe. So, while private equity has always, we think had a place in folks' portfolios.

[00:10:17] It's definitely been a higher topic of conversation for us today, given the market environment that we're in. Listen, we all have been trained to know that past performance isn't indicative of future results. But I think the persistence of the return premium that's afforded by private markets has been a strong one over time.

[00:10:34] So we would argue that it's a reasonable expectation for private markets to outpace public markets by some 300 basis points annually. Now that will ebb and flow based in the market environment, based on the actual types of strategies that are being invested in. I think it's more important given what I just said about current capital market expectations, those 1, 3, 500 basis points of additional performance can really be additive for our clients and for their spending needs.

[00:10:58] So I know we're going to get [00:11:00] into this, but if the entity is in a position from a cashflow standpoint and from a risk tolerance standpoint to take on some level of the illiquidity associated with private markets, we really think the asset class makes a ton of sense. So, Matt, can you describe the process of building a private equity program and how that is different from just investing in the more traditional asset classes?

[00:11:21] Absolutely. And I think this is an important point and probably the biggest point of education and conversation with our clients who are new to the asset class. The biggest difference is that with traditional asset classes, exposure is essentially instant. So, if you're looking to add a 5% target to high yield bonds, you simply choose the manager and buy the fund or ETF, and you're immediately at your target allocation. With private equity, the process is different and can take some time.

[00:11:48] So with PE, the process works by making commitments to a strategy. And then the general partner will call capital down gradually as they're making their investments within the portfolio. So, example, if [00:12:00] a $50 million endowment is looking for a 10% allocation to private equity, that's roughly $5 million.

[00:12:06] Now, if the endowment committed $5 million on the spot, that capital will be drawn down gradually over the course of three to five years, meaning the portfolio would remain nowhere near its target for the first several years after their first private equity commitment. So clearly just getting to a target allocation can take time, but it also takes continuing attention and management because just as you start to get the exposure to the desired level that you're after, the general partners start harvesting their gains from their portfolio companies and then distributing capital back to the institution.

[00:12:39] Leaving you with a need to reinvest the portfolio and make new commitments to get back to your target allocation. In an effort to help clients with this process, we create custom pacing models for all of our clients. So, we take into account the relative details regarding the client portfolio, such as a portfolio growth rate and assumed cash flows for the private [00:13:00] equity commitment.

[00:13:01] So we marry essentially what we know about the client's portfolio and what we believe to be true about the cashflow profile of their private equity commitments that we'll be making. And the goal overall is to paint a picture of how much needs to be committed to annually, to get to the target exposure, and then help the client also understand how much cash is being called or distributed annually based on their historical commitments.

[00:13:22] There was one other thing I would just add before moving on from this point. One thing that's important when building out a private equity program is this topic of diversification. We'd actually argue that the fact that private equity portfolio needs to be built gradually is actually a good thing because it builds in some inherent diversification by vintage.

[00:13:40] We want our capital to be put to work gradually over all parts of the market cycle. So back to the example I gave earlier, that client looking to get $5 million, get to a $5 million target private equity would not make a $5 million target in the current year and then sit on their hands until they get the capital back.

[00:13:58] We would work with them to figure out [00:14:00] what the right pace of deployment would be so that they built their portfolio gradually at different parts of the market cycle. We also want to diversify a number of other factors as well. So, stage, we want to diversify between the venture and buyout opportunities that we spoke about earlier, set their focus.

[00:14:15] We want to make sure that we have a broad representation of the opportunity set in the economy. And then lastly, by general partner, we clearly don't want to have all of our eggs in one basket. We think we select a great list of general partners for our clients, but we want to make sure we're diversified in the event that when one falls out of favor in any way.

[00:14:33] And Matt, these sound practices that you're describing, they certainly apply to a $5 million portfolio commitment, a $50 million portfolio and beyond. But you're also touching on some of the potential drawbacks. What other drawbacks or considerations does an investor need to think about as or before they invest in private equity?

[00:14:57] Sure. I think I mentioned the cashflow [00:15:00] profile that's associated with private equity investing, and I think that's the most key point for our clients and for investors to understand. There is an element of illiquidity here. And I would also call it just a lack of control regarding liquidity. So, it's not a matter of, you know, not ever getting your money back, but you're no longer in the driver's seat of when you can pull the sell trigger to sell a fund or an ETF or a stock. You're at the mercy, for lack of a better term, of the general partner and when they're able to harvest gains.

[00:15:28] So I think a good understanding of the entity’s cash needs, frequent looks at the pacing model that I just mentioned can help to really mitigate that risk. I think another drawback, Bob, is just this issue of the concept of a J-curve, popular term in private equity. But what it basically points out is that in addition to it taking a while to get your capital put to work, initial returns can appear negative within a private equity portrait.

[00:15:52] Due to the impact of fees and early portfolio losers and how long it can take for the general partners to create value in the underlying [00:16:00] companies that they are investing in. So even the best long-term strategies that we invest in can often have periods early on where returns look either flat or negative at times.

[00:16:11] And it can leave some clients or new committee members wondering why did we get ourselves into this? So, as we're building programs for clients and working with them, it's something that we think about a lot and making sure that we try to mitigate the impact of that J-curve as much as possible. Now, that issue clearly goes away once the portfolio is up and running, but it's something really big.

[00:16:30] And then I think the last thing I would mention, and this is one that is very difficult to quantify, but something that Bob and Devon, I know you're very familiar with working with your clients on. It’s just the administrative efforts and burden at building a private equity portfolio can have on an institution.

[00:16:46] So, whether it's just the completion of the subscription documents or the handling of capital calls going forward, we just want to be really upfront with folks in terms of what exactly that means, and how they should go about approaching, building [00:17:00] their portfolio to create the right amount of administrative effort needed.

[00:17:05] So Matt, I think most people who hear the term private equity assume that it's only for institutions or investors with very large portfolios. From your perspective, is that true? Well, Devon, I think the short answer, and you can probably hint at my answer, given some of the examples we've used so far, but I think the short answer is no.

[00:17:22] Although I would certainly say that I understand the misperception out there. I think larger institutions and larger portfolios historically have just been more easily able to mitigate some of the risks that we just talked about. Whether it's just larger liquid portfolios, easier access to the best managers, a bigger investment staff, or an investment committee comprised of members who are just simply more well-versed in space.

[00:17:46] It's clear to see why larger investors and larger portfolios would be more easily able to build out portfolios in the private equity space. We are definitely seeing more and more conversations with our smaller clients. [00:18:00] I think we talked about the capital market expectations being one of the bigger drivers there.

[00:18:04] I think some of the access points, meaning vehicles that the general partners have created, have created much more opportunity for smaller investors to build really high-quality portfolios that can really help their long-term returns. I think what we need to do is to be thoughtful about the unique situation that we're in and make sure that we're able to build a portfolio that is diversified enough on all the levels that I mentioned earlier.

[00:18:28] This can be done through a variety of approaches that could be sort of a core and satellite type portfolio construction, or it could even be a fund to funds, which when constructed thoughtfully and with close attention paid to the fees, can be a simple solution for smaller clients to gain access. So, I would just say, you know, we're trying, we acknowledge that there is an illiquidity premium.

[00:18:49] There is a persistent level of out-performance from private markets. And so long as we can build a portfolio that's appropriately diversified and still able to harvest that return premium, we'd like [00:19:00] to do it. We recently were working with a $60 million client of the firm who was looking to beginning investing in private markets.

[00:19:06] We worked a lot with them, modeling cash flows over different target allocations and circled on 10% as an appropriate target for them. And for that client, with that target and that size, we settled in on a mix of a fund-to-fund core. And then we've been working with them to add some satellite sort of more niche allocations around it.

[00:19:25] The fund to fund also, interestingly enough, had exposure to secondaries and co-investments which we thought would help get the capital put to work and mitigate any potential impacts of the J-curve, which we talked about earlier. So, the takeaway there is, I think, depending on your client's size, we just need to find the solution in the portfolio that is appropriate for that situation.

[00:19:45] Matt, that's so helpful. And the work that you and your team performs, I like that it spans from the smaller, maybe fund-to-fund strategy and core satellite and so on, on up to the client we're speaking with a [00:20:00] little bit earlier today, billion dollar portfolio with actually not only I would say traditional private equity investment sleeve, but actually an impact portfolio.

[00:20:11] So it is one of the things that as you continue to unpeel the onion in the private's world, I think makes it so interesting and so opportunistic. So Matt, maybe you could talk a little bit about the state of private equity today and the activity level I opened by talking about, really the level and how well the S and P 500 and other investments have done year to date.

[00:20:36] And you can or cannot comment, up to you, on how PE has done, but more specifically the activity level this year, the dollars being raised and such compared to previous years. Well clearly, with all the positive attributes that I've described regarding private markets thus far, combined with sort of the low interest rates and potentially muted public equity returns.

[00:20:59] We've sent a ton [00:21:00] of demand in private markets and we've seen therefore a ton of capital raised across private markets. Clearly private equity, we wouldn't make the cases fully disconnected from the relatively high valuations that we're seeing across other capital markets. But we'd argue that if you buy into the idea that you can't time traditional markets, you definitely can't time private markets.

[00:21:20] So we're still advising clients to maintain their PE programs and construct portfolios with what we think are the highest quality GPs out there. One thing I would point out, Bob, to your, the point of your question regarding the capital raised. One thing that we saw over the first half of the year, it was a continuation and sort of the concentration at the top.

[00:21:38] So the largest nine funds in the market raised over half of the capital raised in private markets through the first half of the year. So, when we're working to source opportunities and picking where we want to focus our time and what type of general partners we're looking to invest in, we've actually opted to try to focus outside of where the capital has been raised in the greatest amounts.

[00:21:59] [00:22:00] So we were trying to find that other 50%, which represents hundreds of fund opportunities, because we think the smaller funds are able to work in deals that are less competitive with less capital chasing after them, potentially able to create returns that we've seen. They're more akin to the returns we've seen historically, as opposed to what we're expecting today from other capital markets.

[00:22:21] That's helpful, Matt. So, we've covered a lot in today's conversation. Is there anything before we close that you'd like to share with investment committees who are considering starting a PE program or who are considering adding to their private equity portfolio? I think I would just, you know, really sum up what I said with, I think private equity can seem a somewhat daunting or complicated task, but we really think it can be additive to portfolios.

[00:22:47] And I think between our consultants and our research staff, we're really happy to spend the time to help you get over the hurdles, to understand that this is really, uh, much more straightforward than maybe it seems out of the [00:23:00] surface. So, whether it's working through the pacing model, understanding cashflow needs.

[00:23:03] And how you'd be impacted with some level of liquidity or looking at the actual underlying options to construct the portfolio. We can really take this in a number of directions and we should be able to find a solution that is able to gain the exposure you're looking for, which we think can add to returns, uh, on a risk adjusted basis over the long term.

[00:23:22] Matt, this has been so helpful. We really appreciate you sharing all of this with our listeners. And before we let you go, I couldn't agree more with what Devon said earlier. You're the perfect combination of super smart and super user-friendly. And that's a great combination, but let just get an idea of what Matt Kaminski, the person, is about.

[00:23:43] And perhaps you can share with us what you enjoy doing outside of work and outside of your volunteer efforts. Sure. Happy to do that. Um, I guess personally, you know, I really enjoy to fish. I also enjoy going for long bike rides. I'm an avid sort of road bike cyclist, but at the top of the [00:24:00] list, for sure, Devon mentioned my two little ones, so I have a seven and a nine-year-old, Owen and Claire.

[00:24:05] And I actually, it's been quite a bit of time with them and coaching their respective baseball, softball, and soccer teams. And that's probably the activity that I find the most joy in right now, just seeing them out there, learning those sports and working with their teammates. That's great.

[00:24:22] Thank you so much for joining us today, Matt. You have provided such wonderful insight and I think really have provided an accessible framework for private equity, where maybe folks that weren't familiar with that part of the market when they began listening to this podcast might feel a little less daunted right now.

[00:24:42] So that's why we really appreciate your time. If folks want to learn more or maybe access resources, how might they go about doing that? Can they reach out to you? Was there a website you would point them to? We're always comfortable to have conversations. We really love the markets. And [00:25:00] as I said, we'd love to see more of our clients participating in them.

[00:25:02] So I'd say feel free to reach out to us. We also, twice a year, produce papers just with updates on private markets and those are located on our website. Well, thank you again. We really appreciate you taking time out of your very busy day. So, thanks so much for joining us. Great, thank you. Matt, thanks so much.

[00:25:19] And thanks so much to our listeners. Matt provided great insights and I'll just touch on the resource that Matt mentioned. The private markets team, they just issued this twice a year timely update that touches on growth in PE this year, as well as a lot more. So, we'll be sure to include that link in our show notes, and you can also find it at Fiducientadvisors.com.

[00:25:40] So, to all you good stewards, thanks for investing time to help your nonprofits prosper. We'll connect with you soon on the next episode. Thank you for listening to the Nonprofit Investment Stewards podcast. Click the subscribe button below to be notified of new episodes and visit Fiducientadvisors.com for more information. The information covered and posted [00:26:00] represents the views and opinions of the guest and does not necessarily represent the views or opinions of Fiducient Advisors.

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