North Sky
CAPITAL

Second Quarter 2014

The High Cost of DIY

Quote of the Quarter:

“The handyman’s secret weapon? Duct tape.”

- Red Green

Summary

- Large institutional investors, such as CalPERS and the Harvard endowment, directly select private equity funds for investment out of a universe of over 2,500 firms. Such investors have dedicated staff for this purpose.

- A few mid-sized institutional investors are adopting this Do-It-Yourself (DIY) approach to private equity, but without the dedicated staff. Cost-savings and some familiarity with private equity are often cited as factors in this decision.

- DIY strategies, without proper staffing, insights and oversight, may lead to fiduciary liability and a misallocation of trustees’ time and attention, and can be unduly burdensome to an already-stretched-too-thin staff. Some amount of duct tape is often required to hold this initiative together. We estimate the cost of a DIY program is at least $375,000 per year.

- Very few investment consultants are properly staffed to perform this role.

- Funds of funds provide a necessary and valuable service to the vast majority of investors who lack a dedicated in-house private equity team.

- North Sky can deliver a fully-diversified, professionally-selected portfolio of private equity funds and co-investments far cheaper and easier than the DIY approach—for what amounts to an extra 15bps per year and 0.5% of carry on the back end. **Your private equity allocation would have to exceed $250 million to justify a DIY approach on purely a cost basis, while ignoring other factors like experience, access, selection and accountability (performance).**

- Over the last 15 years, the top quartile private equity return has exceeded the median return by approximately 7 percentage points—an immense disparity versus other mainstream asset classes. Therefore, with respect to private equity, fiduciaries should focus on maximizing the chances of achieving top quartile results, rather than prioritizing platitudes about the price of getting there.

Much has changed since we started this business in early 2000. At that time, private equity was still relatively unknown to all but the biggest institutional investors. Then in May 2000, David Swenson from Yale’s endowment published *Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment,* and private equity stepped onto center stage. Demand for venture capital and leveraged buyout funds increased thereafter, and funds of funds were used by many as the vehicle of choice to access the asset class. Today, private equity is clearly a mainstream component of endowments, pension plans, foundations and family offices (large and small) and is becoming increasingly commonplace within the portfolios of high net worth individuals.

We were prompted to write about the DIY topic after encountering a handful of mid-sized institutional investors who told us they “didn’t like funds of funds because [we] added an extra layer of fees.” True enough in isolation but that perspective gives no consideration to:

(1) the value one might receive in exchange for that extra layer of fees,

(2) the variation in fee structures in the fund of funds industry and

(3) the cost in terms of dollars, effort and investment performance of trying to select from the array of private equity funds on one's own.

The notion of a DIY private equity program also seems to defy human experience. To wit, let's compare public equity investing with private equity investing.

When it comes to public equity, most institutional investors invest in broad market indices like the S&P 500 and MSCI ACWI and/or hire specialists to pick a subset of publicly traded companies for investment (large cap growth, small cap, etc.). This is the time-tested approach, in part because trying to have a board of trustees or a multi-person investment committee pick individual stocks would be difficult in terms of analyzing the thousands of available choices and reaching consensus on individual companies. To underscore this point, imagine any group of three or more people coming to agreement on the 20 best companies in the S&P 500. Not likely. Further, actively tracking performance and buying and selling shares based on intrinsic and market signals would be a full-time job, and clearly the trustees/committee members have other fiduciary matters that also require attention. So they focus their attention on determining what percentage of their assets should be allocated to public equity and outsource the stock-picking duties to specialists.

The same outsourced approach should be (and often has been) the norm in private equity, utilizing specialists for their knowledge and expertise of the 2,500+ buyout and venture capital firms worldwide. The need for specialists is even more acute in private equity, where the prospects, performance and capabilities of investment opportunities are so opaque and the disparity between top quartile, median and bottom quartile performance is so large. It takes a tremendous amount of time and effort to gather sufficient information to make informed private equity choices. Pattern recognition honed from year after year of meetings with private equity managers and a keen sense for which private equity teams are waxing or waning are critical aspects to intelligent fund selection. Nevertheless, some mid-sized institutional investors are opting for the devil-may-care approach. Perhaps one of their trustees has a friend from business school who is now at a well-known private equity firm. Perhaps their consultant has a few suggestions from its research team, but does that team have the insights, experience and track record of a seasoned fund of funds? That question is not so easily answered given the high turnover or re-positioning of staffers at many consulting firms. Perhaps this different approach to private equity vs. public equity will work out just fine, but we think a course reversal is in the making.

At North Sky, we work hard to ensure that we make smart, informed decisions, and eliminate risk where experience allows us to do so, in order to build well-diversified portfolios. We have contemplated the "extra fee" concern for a long time and have demonstrated over our last three funds that we have a compelling response to it. We can deliver all the benefit of one of our funds—professional selection, monitoring, reporting and administration (cash flows, stock sales, taxes, keeping managers' interests aligned with that of our investors)—and it only costs an "extra" 15 bps annual fee and 0.5% of carried interest. A pretty neat trick, if we do say so ourselves. So in defense of funds of funds, especially our hybrid approach, we thought it would be instructive to show a (slightly tongue-in-cheek) comparison.

	North Sky	**DIY**
Experience	14 years	Somewhere between "a little bit" and "unquantifiable"
Review of 2,500 managers in the universe	Continuous/avg. of 300 annually	Sporadic/maybe 5-20 annually?
Endless parade of managers through your office	No	Yes
Trustee attention required	Once/upfront	Ongoing/every meeting
Access to top firms	Yes	Depends on whether your trustees went to the right business schools

Secondaries	Yes	Probably not
Accountability	You “fire” us if we don’t perform/we don’t pay our mortgages	How do you fire the trustee in question if he/she just donated $10mm to your business school? How do you fire a research analyst who left the consulting firm five years before the results of his picks became known?
Aligned interests	Yes, paid a success fee (i.e., carried interest)	Perhaps; must set long-term compensation plan for staff with expectation that they stay throughout term of investment
Track record	13 funds. Transparent. Mature predecessor funds to PEP V are all top quartile.	Typically none/NA
Monitoring	Proactive/continuous	Best efforts/when time allows
Performance reporting	Detailed/quarterly	General/annually
Administer stock distributions and cash flows	Easy (done for you/ compiled quarterly)	Burdensome/ad hoc
Cost (see calculations below)	15bps annually and 0.5% of carried interest paid at the end. For reference, 15 bps on a $25mm commitment = $37,500 annually	Minimum of $375,000 annually

Cost Calculations: To compare a DIY program to our funds, we looked at the incremental cost above the annual management fee and carried interest of the underlying VC, LBO or other private equity managers that are selected for a typical private equity program—a 2% annual management fee and a 20% carried interest fee.

Extra Cost of a DIY Internal Private Equity Team

Annual Expense	In-House Costs
Salary for 1.5 analysts	125,000
Benefits	30,000
Office/Overhead	25,000
Support Staff	25,000
Legal	60,000
Travel	30,000
Accounting, audit, custody	80,000
Long-term comp to align staff interests	?
Additional payment to consulting firm	?
Total	≥ $375,000

Extra Cost of a North Sky fund

Starting with our second series of funds (PEP II), we have been innovators regarding cost in our industry. We have worked hand-in-hand with our investors to create a compelling fund structure that delivers a comprehensive, well-diversified private equity vehicle at the all-in equivalent of a 2.15% management fee and a 20.5% carried interest.

	Fund Investments 75% Allocation		Co-investments 25% Allocation			
	Underlying Manager	North Sky	Underlying Manager	North Sky	Weighted Average Fee	**Extra Cost of Our Services**
Management Fee	2%	0.65%	--	0.65%	2.15%	**0.15%**
Carry	20%	5%	--	10%	20.50%	**0.50%**

Conclusion

So for 2/20 plus at least $375,000 per year, you can throw darts at a dart board and do the heavy lifting yourself. But for 2/20 plus 15bps per year and a sliver of a success fee, you can have us (sans duct tape).

Upcoming Events

We are regular speakers and attendees at key industry conferences. We hope to see you at these upcoming conferences:

September 22-24 — **National Coordinating Committee for Multiemployer Plans,** Hollywood, FL www.nccmp.org

October 12-15 — **60th Annual Employee Benefits Conference,** Boston, MA www.ifebp.org

---

North Sky Capital Contacts

Scott Barrington
Managing Director and CEO
(612) 435-7170
sbarrington@northskycapital.com

Danny Zouber
Managing Director
(612) 435-7180
dzouber@northskycapital.com

Michael Pohlen
Managing Director
(612) 435-7190
mpohlen@northskycapital.com

Mark Austin
Managing Director
(612) 435-7160
maustin@northskycapital.com

Gretchen Postula
Head of Investor Relations
(612) 435-7177
gpostula@northskycapital.com

Denise Galvin
Chief Financial Officer
(612) 435-7166
dgalvin@northskycapital.com