Role of the Advisor

Considerations for Supporting New and Evolving Mandates

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Forward

This paper summarizes the issues an LP (particularly an LP considering a new or revised private equity mandate) should consider before making important decisions about the management of its private equity portfolio. Specifically, it addresses the complex nature of utilizing an advisor for specific investment functions. The goal of this paper is not to endorse outsourcing, nor any particular outsourcing model. That decision is highly specific to the characteristics of individual institutions, including their mandate, age, size, oversight, and available resources. Rather, this paper attempts to identify the risks and opportunities associated with these highly-sensitive decisions, which can have a long-lasting impact on the return and composition of a portfolio.

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DISCLAIMER: This installment of the ILPA White Paper Series (Paper) reflects the views of the participants on what a Limited Partner should consider while determining how advisors can support their portfolio management functions. No Limited Partner should use this Paper as a substitute for its own determination as to what information such Limited Partner will need or desire with respect to any particular investment or portfolio of investments.

Why Use Advisors?

Institutional investors in private equity funds (“Investors” or “LPs”) come in a variety of organization types, with many portfolio-management models. There are Investors where a single person makes investment decisions for all asset classes including private equity. While others use teams that are organized to specifically invest in private equity funds. The setup is typically driven by the size of the Investor’s commitment to private equity and similar private investment funds (collectively, “PE”). The complexity of PE investing can be simplified by the tools available – Investors with smaller teams can decide to invest in a single manager or hire an external, PE “expert” advisor to directly-manage the portfolio on the Investor’s behalf. The structure of the PE unit is typically the result of the available resources, including talent. Those resources can be internal or external, and each comes with benefits and costs.

All PE Investors rely on some form of advisory services. It may be as little as using benchmarks or fundraising calendars, or as complete and complex as entrusting full discretionary authority via a Gatekeeper model. The scale of advisor engagement is driven by the perceived benefit (e.g., higher-return potential, more diversification) and cost (i.e., fees paid, versus salary and travel for internal employees).

> With maximizing return in mind, the decision to increase or decrease the role of advisors has multiple consequences.
>
> They can be monetary but may lead to unintended ones such as new liability, headline, or compliance risk.

A goal of every Investor is to maximize the return from investments, in relation to the accepted level of risk. LPs can have portfolios of different sizes and complexity, dictating the size of investment staff and other resources needed. The staff size, along with its experience, skills, and available tools are the resources necessary to manage the portfolio. By optimizing available resources and applying them appropriately, Investors position themselves to add value and achieve expected returns. Constantly faced with finite resources, despite ever-changing mandates, Investors need to decide which internal activities are adding the most value, and which could be better addressed by advisors.

The need to hire an external resource often comes either at the initiation of the PE program, a strategic shift from an existing portfolio strategy, or as a reaction to a situation that causes disruption in portfolio management (e.g., unexpected staff-departures). Regardless of the direct cause, the decision to utilize additional external resources should always be considered within the existing investment policies and goals. Proper planning of your advisor-mandates will facilitate the most efficient implementation and selection of providers, while maximizing overall value.

A more nuanced approach can apply to a situation where a PE portfolio is large enough or required to invest in niche parts of the market. There are also previously-successful Investors that - due to changing market conditions or internal requirements - find it necessary to allocate outside of their core competencies, investing in previously unexplored strategies. Even if there is an internal objection to use a third-party service provider, the long-term nature of PE investing may justify a short-term engagement with an outside specialist. Over time, as the Investor’s acumen in the new strategy improves, the activities can be internalized. This approach reduces potential short-term return and/or poses additional expenses, but also greatly limits the risk, while providing diversification.

For example, some Investors face unique circumstances where they may be required to invest a portion of their portfolio in funds that may generate benefits other than return on investment. There are many programs that require the LP to invest locally, or into socially-important investments. Those types of investments may not satisfy regular investment criteria and may be problematic to find and execute. Additionally, they can be relatively small compared to the rest of the portfolio. These types of investments are ideal candidates for using external-support. The service provider typically draws the capital for such investments from several LPs, spreading the cost between the Investors while maintaining the return requirement.

While an increased reliance on advisors seems to be more flexible than building internal resources, the cost and associated complication of re-internalizing or switching service providers must also be part of the decision. From the perspective of value-add/cost analysis, this is most important. But for many Investors, other considerations need to be contemplated. Engaging advisors shifts away some risks, but also exposes Investors to new ones (e.g., fiduciary, reputational, third party). It generates cost and reduces internal employment and advancement opportunities. It also limits internal knowledge development.

To explore these opportunities and challenges, this paper will focus on two areas:

1. **Determining the Optimal Advisor Engagement –** What unique organizational constraints and objectives will influence an LP's decision to use an advisor? These constraints and objectives are measured across the following themes:
   - **Fees Relative to Alpha –** Can advisors provide better cost-adjusted returns?
   - **Investment Efficiency –** Can advisors provide services that the LP cannot?
   - **Manager Access –** Can advisors help an LP increase its allocation to "top-tier" GPs?

2. **Consultants vs. Fund of Funds –** For those electing to expand their advisor engagement(s), what are the differences between the two main advisor types (consultants and fund of funds)? Additionally, under what situations should an LP consider one versus the other (as shown in the "Situational Matrix" on pg. 11)?

Determining the Optimal Advisor Engagement

Portfolio-resourcing decisions must be constantly analyzed from the perspective of risk and return. A measurable cost and benefits assessment needs to be paired with long-term risk analysis. For example, assumptions about growth of the portfolio may impact capital needs and allocation. Similarly, such assumptions should have an impact on any need for future resources. If the need is predictable and likely, an internal resource should be considered. If the required services can be easily contracted and terminated/internalized, the cost/benefit analysis should determine the optimal model. Failing to understand the full cost of using advisors can have a long-term impact on performance. Investors need to make sure that the services they plan to contract will support their long-term performance expectations. While advisors seem to offer more general flexibility, in many situations, a subsequent pivot away from the service provider may be complicated, unpredictable, and costly.

The type, size, and maturity of the portfolio should be considered. Diversified, multiple-name, and mature portfolios can be small in terms of value, but might require more resources or expertise than new, highly-concentrated investments. The requirements of the former may be heavily oriented towards accounting, legal, and reporting services. The latter may require broader market analysis and strategic advice.

Investors should always consider which activities are core and necessary to be performed internally, and which are better served by a third party. For example, there may not be enough employees to perform all core functions, which coupled with a limited budget, can lead to bottlenecks that negatively-impact certain investment decisions. The size of the total portfolio and relative position of the PE investments may dictate the need to entrust full authority to advisors on select functions. Likewise, the perceived level of expertise needed and requirements by the overseeing body (board, investment committee, etc.) may force the Investor into relying heavily on advisors. Regulation can create a need for external resources – a Prudent Person Opinion is a good example of how an LP is required to obtain an opinion from a third party in order to invest.

A strategic review of the portfolio should conclude with recognizing internal opportunities and limitations. Additionally, available resources (i.e., human capital and budget) need to be viewed from both the current and future perspective. Human capital decisions have long-term implications. Hiring external help could be costly, but the efficiency and value-add of the service provider can lead to an increase of return or protection from unexpected expenses.

Fees Relative to Alpha

Studies suggest that while advisors are influential in PE investment decisions[1], and provide some level of outperformance (or "Alpha")[2], the benefits are rather limited to specific types of investments (i.e., Venture Capital or "VC"). In some situations, the additional layer of fees paid to advisors often reduces or eliminates any potential Alpha.

As suggested by these studies, LPs primarily focused on non-VC strategies (e.g., Buyout) may be better off without advisors supporting their investment decisions (i.e., in-house management). Furthermore, one of these studies suggests that an advisor's ability to direct investments toward its preferred GPs often inflates the size of the fund or reduces commitments during market downturns (when perhaps investment opportunities are most attractive). This results in lower expected returns.

A closer look at allocation and strategy is warranted. One of the aforementioned studies suggests that an advisor can generate Alpha and justify additional fees if investments are made outside of a generalist approach, and specifically in VC[3]. Due to limited data, the study does not consider other types of niche investing, but many characteristics of such investments are similar to VC (e.g., limited access, smaller funds, less transparency). The assumption that niche investing (ex. VC) through advisors will result in Alpha-generation may not have the empirical evidence, but the logic is strong enough to at least consider.[4]

Investment Efficiency

Including Alpha, the value-add from advisors is typically based on the: 1) Efficiency of the advisory business, versus the 2) Restrictions or limitations of the Investor. Put another way, the advisor gives the LP an opportunity to invest in some way that would otherwise not be possible. That

[1] "Picking Winners? Investment Consultants' Recommendations of Fund Managers", Journal of Finance, Tim Jenkinson, Howard Jones, and Jose Vicente Martinez

[2] "Financial Intermediation in Private Equity: How Well Do Funds of Funds Perform?", Robert S. Harris, Tim Jenkinson, Steven N. Kaplan and Ruediger Stucke

[3] The study from Harris, et al appears to ignore a commonly-known fact that many large Institutional investors (typically public plans) were excluded from directly investing in the most successful VC GPs, who instead preferred to raise capital from advisors. Obviously, this would result in higher returns for the advisors who were the preferred fundraising sources by these VCs.

[4] The study from Harris, et al seems to support this belief, but does not take internal costs (e.g., travel) into consideration.

value-add, which is exclusively generated by the advisor, can be extremely attractive. Of course, it comes with a price and unique risks.

The advisor's role can often be described as "Eyes, Ears, and Legs on the Ground" – the advisor acts as an extension of a single LP and represents that LP, when necessary. Geography, depth of market, or level of expertise may all be reasons why an LP needs a third party to help manage the portfolio. An advisor serving multiple clients will attract talented employees and supply them with resources at a cost impossible to bear by a single LP. Those employees will create high-value content that's sold to several LPs. In that way, the resources are used efficiently.

While considering a new advisor engagement, Investors must weigh the lost benefits from not investing directly. Typically, direct investing into PE funds is the best way of building a team's institutional knowledge and experience.[5] But in the early stages of a PE program, advisors are excellent at helping clients manage their relationships and get the LPs "up to speed" with learning about a particular GP or market. However, the firsthand experience will always have its benefits that unfortunately cannot be passed from advisor to client. Additionally, a direct relationship between the GP and LP, without the advisor as an intermediary, provides benefits that otherwise are retained by the advisor (e.g., a more efficient co-investment pipeline). While the relationship between the advisor and GP will benefit the Investor, it will never be on an exclusive basis.

Manager Access

Limitations on manager access are typically associated with VC investments. Some top-tier VCs will not accept commitments from large Investors (often due to their reporting requirements) or will significantly limit the allocation to their funds. Other VCs will "award" certain allocation to their flagship funds only if an LP supports their more-unproven products. Many Investors have circumvented these issues by allocating through an advisor, who are typically viewed as more reliable and scalable sources of capital for such VCs. Of course, the expected top-quartile performance from this allocation is partially-muted by the drag from the additional layer of fees charged by the advisor.

However, these access limitations are not unique to VCs. Successful Buyout managers can turn down LPs or reduce their desired allocations. Similar to VCs, a commitment from an advisor is easier to manage and provides more stable source of commitment to the Buyout shop.

While considering a strategy of using an advisor to secure allocations to "premier" funds, Investors should consider that large investment allocations allow LPs to negotiate unique terms or share the best ones (i.e., Most Favored Nation clause). From that perspective, allocating through an advisor that's able to commit on behalf of several "like-minded" Investors can provide access to GPs at terms that are not available to them individually. Investors considering an advisor strategy focused on accessing top-tier managers should be mindful of how an advisor has approached past negotiations to see if there's Investor/advisor alignment.

[5] Direct investing into private companies, bypassing PE funds, is also a strategy utilized by some investors. But this paper concentrates on advisor services related to fund investing.

Consultants vs. Fund of Funds

As previously discussed, under certain circumstances, advisors can be utilized to optimize a PE portfolio. For the remainder of this analysis, the advisor is defined as a third-party entity that either:

1. Focuses on delivering discrete (or bundled) services designed to support individual (or all) stages of the fund-investment process (a "**Consultant**"), including: sourcing, due diligence, investment selection, deployment, monitoring, and/or divestment; or
2. Provides all of the aforementioned services as part of a single product, typically through a dedicated legal entity that is managed exclusively by the advisor (a "**Fund of Funds**" or "FoF"), with only minimal oversight by the Investor

Consultants and FoFs often provide the same services. Consultants are generally capable of providing a wider breadth of services, with a customer-centric approach to tailoring such service to client needs. FoFs, on the other hand, tend to focus more on their core investment strategy as a means to deliver their form of value-add, while other services are typically not tailored to individual clients.

Traditionally, the distinction between a Consultant and FoF was based on a level of discretion that the LP had when it came to invest in funds. Consultants offered the necessary:

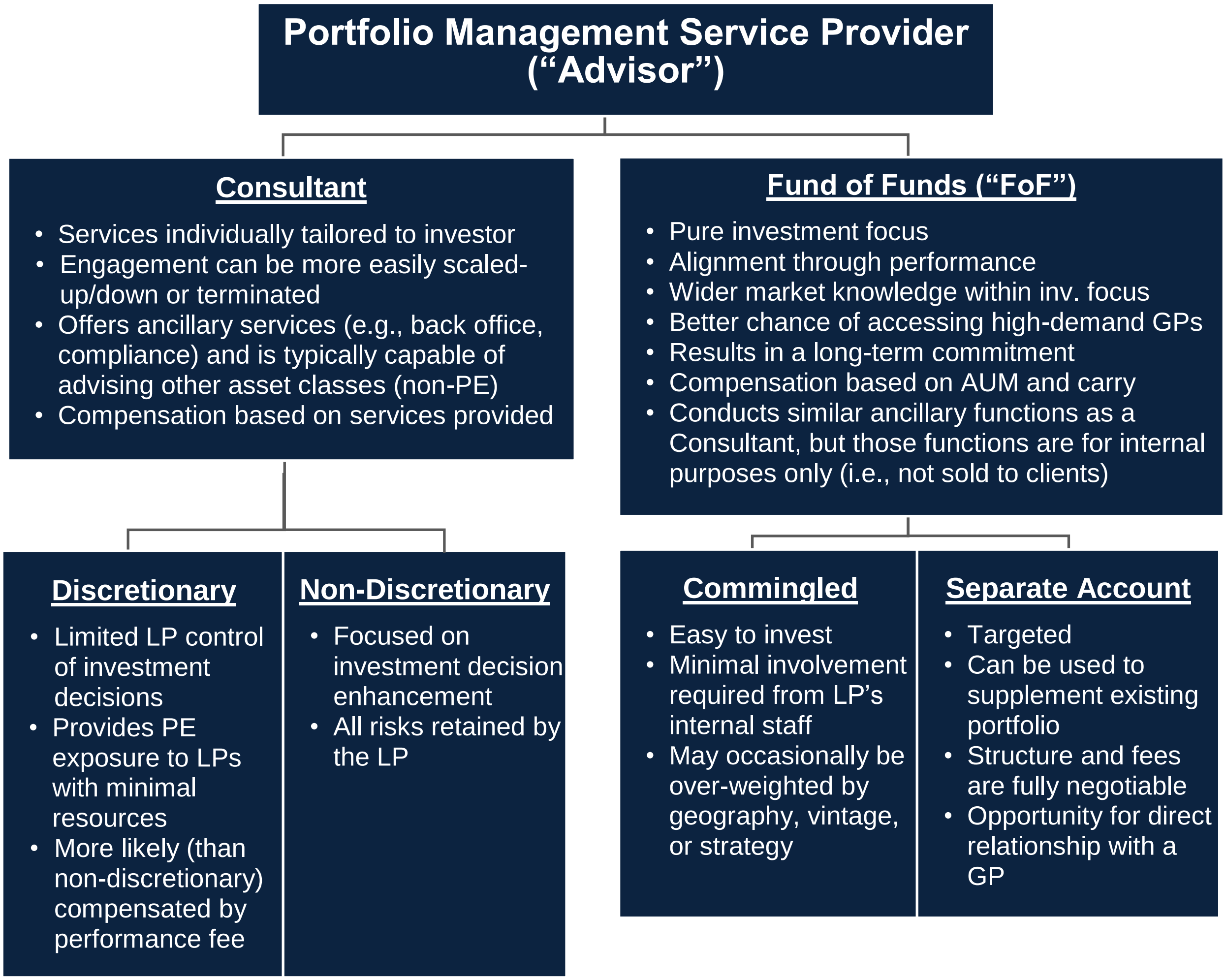
- **Information** - Reports, analysis, and recommendations
- **Personnel** - To perform due diligence, represent the LP, and report to boards
- **Tools** - Benchmarks, fundraising calendars, conferences, and forums

However, Consultants would leave the final decision to invest in a fund to the LP. FoFs on the other hand, once committed to, would have a defined but significant discretion into where, when, and how much to invest. More recently, customizing and tailoring the service to the need of the client has made it more difficult to clearly distinguish between Consultant and FoF. Consultants now offer FoF-like products or have a full discretion over Investor mandates, while some FoFs now provide more Consultant-like services.

Investors using advisors look for ways to align their interest with the service provider. The Consultant and Fund of Fund models significantly vary when it comes to how each one is compensated. The Consultant charges fees for services – typically pre-agreed, perhaps based on service hours per specific type of consultant (i.e., their level of expertise). In more complicated and broad arrangements, a fee can be based on total assets under management. Obviously, a dissatisfied LP has an option to terminate the contract with a Consultant. So, the Consultant will always try to provide best services, as it leads to repeat business and builds reputation. However, most Consultant compensation models do not directly tie the quality of service with the compensation. In that sense, Fund of Funds are more closely aligned with the LP, as a significant portion of their potential compensation comes from carried interest – a performance fee (of course, FoFs are also compensated via management fees, which are often not tied to performance).

When it comes to deployment of capital, it's clear that there are conflicts of interests for both types of advisors. FoFs may be interested in supporting their relationships with a GP, at the cost of not negotiating the best terms for a single LP. A successful fundraising can lead a FoF to invest disproportionately into a single fund or outside of a GP's core strategy. FoFs can also favor their long-term, larger LPs over newer, smaller clients. Similarly, a Consultant can favor certain GPs because of existing relationships with such GPs. Due to a large expense associated with covering more GPs (e.g., due diligence), the Consultant may prefer directing their clients' attention to well-covered, already-underwritten managers. From the GP perspective, FoFs provide larger pools of capital and are easier to work with. The full-discretion Consultants still need to represent each client separately, which adds to the GP's administrative burden. It can be a reason why FoFs may have better access to the GPs that are in high-demand and/or offer limited allocation for new Investors.

The following graphic and the subsequent sections of this paper provide additional color on the differences between Consultants and FoFs, as well as sub-categories within each provider:



Portfolio Management Service Provider ("Advisor")

Consultant

- Services individually tailored to investor
- Engagement can be more easily scaled-up/down or terminated
- Offers ancillary services (e.g., back office, compliance) and is typically capable of advising other asset classes (non-PE)
- Compensation based on services provided

Fund of Funds ("FoF")

- Pure investment focus
- Alignment through performance
- Wider market knowledge within inv. focus
- Better chance of accessing high-demand GPs
- Results in a long-term commitment
- Compensation based on AUM and carry
- Conducts similar ancillary functions as a Consultant, but those functions are for internal purposes only (i.e., not sold to clients)

Discretionary

- Limited LP control of investment decisions
- Provides PE exposure to LPs with minimal resources
- More likely (than non-discretionary) compensated by performance fee

Non-Discretionary

- Focused on investment decision enhancement
- All risks retained by the LP

Commingled

- Easy to invest
- Minimal involvement required from LP's internal staff
- May occasionally be over-weighted by geography, vintage, or strategy

Separate Account

- Targeted
- Can be used to supplement existing portfolio
- Structure and fees are fully negotiable
- Opportunity for direct relationship with a GP

Consultants

Consultants can be engaged for single, non-discretionary tasks (e.g., individual research, accounting review) or for a complete outsourcing of all LP roles. They may have a very narrow level of involvement (e.g., simple benchmarking), or a deeper level of analysis (e.g., review of portfolio with custom benchmarking). Their involvement may be needed for tactical, short-term decisions (e.g., recommendation to invest in a single fund), or for strategic, long-term advice (e.g., portfolio allocation and construction). The best part from an Investor perspective is the ability to use them as little or as much as needed. The LP may decide to use a Consultant for its back-office operation, and then later decide to contract-out its monitoring and underwriting functions to a separate Consultant. Or, a fully-outsourced portfolio can be partially brought back, with core functions managed internally and the less strategically-important functions performed by Consultants. Consultants can have complete discretion, with just a layer of supervision by the Investor. Or every activity can be shadowed by internal LP employees. Regardless of the Investor's portfolio size, the flexibility to include an expert third party into targeted components of the investment process can free up the internal resources to focus on core, high value-add activity.

With a "Gatekeeper" consulting model, popular with smaller (staff size) or newer (to PE) Investors, the Consultant assumes a significant portion of the investment-decision responsibilities (e.g., portfolio construction/allocation, sourcing, screening, due diligence, execution, monitoring, and termination). However, the scope of services can still differ significantly between LPs. In some cases, the Investor's internal staff is minimal, and the Gatekeeper has full discretion, acts as the LP's extension, and reports to the governing body of the Investor (i.e., board/investment committee). Other LPs use their Gatekeeper to pre-screen opportunities and provide market research (top-down and bottom-up), but the investment decision is retained with the LP's staff. Under Gatekeeper models, a fee is typically based on assets under management. But it may also include a performance fee.

Some Consultants focus on specific portions of portfolio management. Through their expertise/ efficiency, and their ability to tailor their services and provide seamless integration with the LP, they can completely take over some functions for an Investor. Accounting, tax, reporting, and monitoring – back and middle office functions – are great examples of such services. The Consultant typically charges a flat fee for those services. LPs tend to keep "pools" of such Consultants and replace them when needed.

Fund of Funds

Fund of Funds can perform most of the functions that Consultants offer. But in most cases, the difference is that all of those functions serve the FoF's core activity of making investments on behalf of their fund vehicles (and not necessarily to support the management of any single client's portfolio). Focus is given to selection and placement into the best funds. While not typically offered as separate services to LPs[6], main FoF activities include constant market review, ranking of existing managers, monitoring of key partner movement, and formulation of new products and funds. FoFs often seed new GPs or drive the restructuring of existing ones (occasionally taking over management of the fund). The expense of running such operations is not in any way billed directly to an LP (unlike Consultants). Perhaps the easiest way to understand the difference between Consultants and FoFs is how the internal staff is perceived from an accounting standpoint. Most teams within a Consultant are viewed as profit-centers, generating revenue via billable hours. For FoFs, staff members not focused on fundraising are perceived as cost-centers until their efforts start earning carried interest for the firm.

Generalist FoFs are typically best suited for LPs that elect to entrust all their investment responsibilities to a FoF. However, this type of approach seems to be in decline (anecdotally), as more LPs are finding they can build their own, equally-successful portfolios without another layer of fees. Based on their reputation, successful and sought-after FoFs are engaged to provide targeted investment opportunities (e.g., VC, Emerging Markets/Managers, Small Buyout, Clean Technology, Co-Investments, and Secondaries). Management fees and carried interest are

[6] To differentiate their products, some FoFs can provide other services (e.g., some form of back office). But those services are unlikely to be customized and seamlessly-provided in a way that Consultants would provide them.

typically assessed. However, many FoFs are becoming creative in how and when the management fees are charged. It’s almost a standard to charge them based on contributed capital (as opposed to committed), but also many forms of fee-deferral and even some forms of tying management fees to minimum return are considered.

The lasting-demand of FoFs that target niche markets makes a lot of sense, as the knowledge and relationship-building in niche markets represents a significant barrier-to-entry for internally-managed LPs. Similar to GPs that invest directly, proven and specialized FoFs tend to be able to charge higher management fees and carry than their competitors.

Another interesting aspect of using FoFs comes from their ability to tailor an investment program through a separate account.[7] The Investor can specify the amounts it wants to invest per year, as well as limitations (e.g., allocating capital per geography, size of funds, focus on industry). Using these limitations, Investors can benchmark this vehicle against an appropriate public index.

[7] Preqin Special Report: Private Equity Funds of Funds November 2017 (http://docs.preqin.com/reports/Preqin-Special-Report-Private-Equity-Funds-of-Funds-November-2017.pdf). Among other topics the paper discusses the changes to the FoF industry, including the offering of alternative structures such as Separate Accounts.

Situational Matrix

Investors often face constant change within their portfolio. It may be driven by their own decisions such as ramping-up/down investment pace, or external forces that require a change in mandate. Advisory services will likely need to shift as changes to the portfolio are implemented. To illustrate this, the following table provides circumstances that may dictate choosing one advisor type over another:

Situation	Considerations for:	
	Consultants	Fund of Funds
New mandate (no prior PE investments in LP's portfolio)	Pros: • Provides maximum flexibility and turn-key availability • Functions and control can be transferred internally over time • Ideal for small institutions or inexperienced teams Cons: • Costly • Not always aligned with the LP	Pros: • Immediate exposure to high-quality GPs and best practices • Better alignment of interest • Easiest model for internal reporting Cons: • Long term commitment with limited exit opportunities
New mandate (targeted investment into a new sub-asset class)	Pros: • Helpful in early stages of research Cons: • General consultant (focused on non-PE asset classes) may be as inexperienced as the Investor, with limited access to sought-after GPs and an inability to optimally deploy capital	• Typically, well-established within its specialty • Cost efficient and allows scalability of capital deployment while focusing purely on desired investments with expected return characteristics
Accelerated increase in assets is required; But w/ no staff increase	• Useful for ancillary work (e.g., performance reporting)	• Secondary FoFs are a particularly good fit; Otherwise, FoFs face similar issues as a new mandate (above)
Steady increase in LP's assets and staff are required	• Allows optimal growth by providing necessary tools and resources (e.g., market intelligence, due diligence, training, reporting, and recruiting)	• Good fit in areas where LP's expertise or geographical coverage is inadequate • Provides exposure in otherwise risky parts of the market (through diversification) but at the cost of an additional layer of fees
Sale of assets / liquidation	• Allows rapid deployment of resources across short time periods (i.e., during the sale process) • Able to provide an independent opinion and sale scenarios	• Potential conflict of interest • Takes long time to liquidate and is often limited by willingness of other Investors
Termination of services (e.g., following a decision to insource)	• Individual services are easily internalized or replaced • Complex, multi-asset engagements require staggered approach to unwind	• A complete termination of services may take over 10 years • Secondary sale is seldom considered as an option, as FoF commitments typically trade at a steep discount

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