FAMILY WEALTHREPORT

INTERVIEW: A New Way To Enter Private Equity - The Index Route

Tom Burroughes, Group Editor, June 8, 2017

FWR talks to a firm crafting a new way for investors, such as family offices, to gain private equity exposure.

For some time now, there has been broadly two ways for an investor to get access to private equity. One route is to become a limited partner of a fund and hope to obtain a seat at the table. The other is to buy shares in a listed fund.

Both routes have their upsides and downsides. With conventional private equity, the trick is being able to find the star performers and put a foot through the door before all the big institutional money gets to the front of the queue. During periods when funds have more money than they can quickly deploy, getting access into the strongest names is difficult. The stars can be really choosy about whom they want to let in past the roped entrance. On the other side, listed funds are clearly simple to participate in - you just buy their shares - but with closed-ended funds, there is always a risk that the fund's shares can trade at a discount to the underlying value of the fund if, for example, the underlying assets are seen as being particularly illiquid, or if the manager falls out of favor with investors, or if share prices are hit by a wider market disturbance. Such a NAV discount can represent a buying opportunity, but persistent discounts can be unnerving and some trusts have share buyback or liquidation policies to contain the issue.

What might be a solution? Is there a "third way" to enter private equity? Well, some number crunchers at Chicago-headquartered DSC Quantitative Group have developed an investible index of private equity returns; the index captures the performance of private equity-backed companies, covering a universe of about 8,000 of such investments.

Wealth managers' interest in DSC's indices, which use Thomson Reuters data, has been "strong", the firm told this publication in a recent call. A few days ago, DSC Quantitative Group was accepted to Mercury Capital Advisors' iFunds™ platform. Mercury is an institutional capital raising platform, based in New York City with an international reach, and such a move will, it is hoped, take the firm's products up another level.

"We think this [index of private equity returns] is very topical in North America, Asia and Europe," Arthur Bushonville, founder and chief executive of the firm, said. "We are trying to provide a more efficient way to access this asset class," he said.

DSC has worked on the project for well over five years; it has demonstrated patience to develop a three-year track record for its private equity indices to build investor credibility, he said. “We have been making a push on the marketing side since just the Fall of last year,” he continued.

There are two indices: a research index that tracks the returns of the underlying portfolio companies of US private equity funds and an Investable Index that is designed to track the research index. What is different about the research index, the firm said, is that it tracks the gross returns of a continuous portfolio of the entire asset class; most other indices, the firm says, track fund-level returns and hence report the “net” outcome once fees are taken out.

As far as the investible index is concerned, DSC assembles what the firm calls a “tracking portfolio” rather as a firm might replicate the S&P 500 with just a subset of the index’s constituents or by using equities not included in the index.

Family office interest

Family offices like the idea of an investable index for private equity because they want to get into the asset class but are put off by high fees in traditional vehicles, Jeffrey Knupp, who is president at the firm, told *Family Wealth Report.* A lot of family offices struggle to achieve a properly diversified private equity program; they sometimes lack the resources to do the necessary due diligence. As a result, an index that spans the entire sector takes care of this chore, he said.

In many cases, a family office in the past might have chosen to go into a fund of private equity funds, but that adds in an additional fee layer.

“Our proposition is pretty compelling to a group [family office] like that,” Knupp said.

Such indices are not full replacements for direct private equity but are useful additions to the wealthy investor’s toolbox, he said.

Another value of an investible index - which can form the basis of an exchange traded fund or some sort of note, Bushonville said, is that it is a relatively low-cost way of gaining access to private equity, particularly for novices or those who are nervous about the liquidity constraints and investment time horizons that come with traditional private equity.

In using an investable index, he said, there is no need for investors to worry about “vintages” or the “J-curve” shape of commitments/returns in an individual private equity investment, he added.