Research Insights from GEM

Pace Yourself: Building a Durable Private Markets Allocation

Executive Summary

Private investments seem to be everywhere these days. Alternatives specialists, traditional asset managers, and tech platforms are all competing with direct deals or vehicles and strategies with the stated objective of "democratizing" access to what was not long ago a corner of capital markets exclusive to large institutions and family offices.

The rationale for private investments within a traditional portfolio construction framework is sound: private investments can—when selected by an expert team with sourcing and underwriting skill—complement and diversify a simple mix of stocks and bonds, potentially enhancing returns and reducing risk. However, as prevalent as opportunities to invest in private markets may be, guidance is limited on precisely *how* to incorporate those assets into broader portfolios. For institutional and multi-generational investors, successfully deploying capital into long-lived private investments requires time, discipline, and most importantly, a plan.

In this paper, we will answer the following:

1. **What's different about private investments?** We will describe the nuances and uncertainties around private investment cash flows.
2. **Why does allocation discipline matter?** We will look at the consequences of unsystematic approaches to private commitments.
3. **How is a commitment plan crafted?** We share what we believe to be best practices from our 15+ years of building multi-asset portfolios across public and private asset classes for endowments, foundations, sovereigns, families, and other long-term institutions.

GEM

Introduction

Private investments have long been a staple in institutional portfolios. Within the last decade, though, we have observed that availability has proliferated, with private investments becoming far more accessible to a wider array of investors pursuing improved risk-adjusted returns and enhanced diversification.

However, the “why” of investing in private investments is clearer than the “how.” Some advisors will diligence potential fund commitments on a one-off basis. Others will make big allocations in some years and skip other years. Some shy away from private investments altogether, wary of the unavoidable complexity, the administrative burden of meeting capital calls in a timely fashion, the lags in performance and tax reporting, and the need to build and adhere to a long-term strategy.

Sourcing and manager selection typically get top billing in conversations around private investments, but one underappreciated aspect of a successful private allocation is the art of pacing commitments to ensure appropriate portfolio allocation.

In this paper, we share our perspective on building and maintaining a large allocation to private investments—the strategy, framework, and discipline required—leveraging our 15+ years of experience deploying the multi-generational capital of our clients.

The Private Allocation Dilemma

The promise of private investments is the prospect for higher returns and portfolio diversification in exchange for five-to-ten-plus years of illiquidity. However, building an allocation to the asset class takes time, and its long-lived nature complicates the task of maintaining a stable portfolio weight. Unlike stocks and bonds, which can be readily bought and sold, ensuring efficient and diversified private investment allocations requires institutional investors to rigorously pace their commitments on an annual basis. At GEM, we define pacing as the consistent approach to committing capital to private investments with the goal of reaching a long-term target allocation.

The traditional U.S. private fund structure is straightforward, but as a quick review:

- A Limited Partner (LP) makes a commitment to a General Partner (GP) fund.
- As the GP identifies attractive investments within the predefined investment period (typically three to five years), capital is called from the LP.
- The GP adds value to the assets over time—through earnings growth, debt paydown, acquisitions, cost cuts, or some other means—and the fund eventually exits those investments.
- After fees and carried interest, proceeds from the sale are distributed to the fund’s LPs in accordance with the Limited Partnership Agreement.

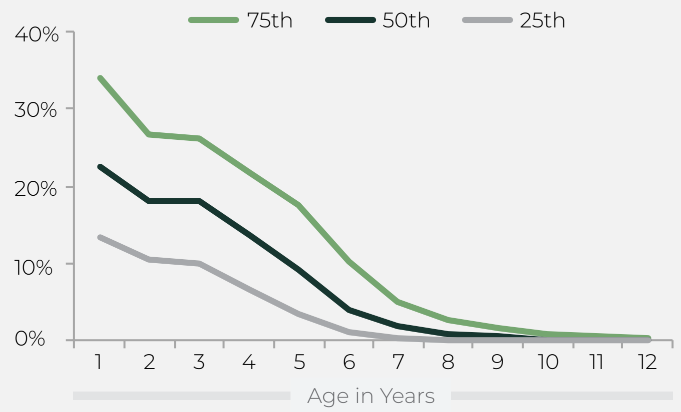
At GEM, we define pacing as the consistent approach to committing capital to private investments with the goal of reaching a long-term target allocation.

There are plenty of unknowns in the process:

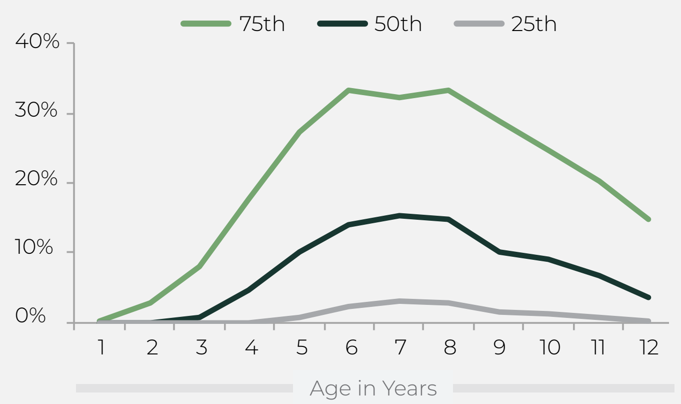
- When will the GP identify attractive investments?
- How long will the GP hold those investments?
- Will the GP recycle proceeds from exited investments or distribute them to LPs?

The consequence of those unknowns is that associated cash flows for any given fund are lumpy. The two charts on the right show the annual quartiles of capital calls and distributions per year as a percent of capital commitments for private equity buyout funds. These results are based on a comprehensive data set, which covers over 2,300 funds representing over $3.8 trillion of capital commitments from 2000-2023.[1] For example, the top chart demonstrates that, although the median buyout fund calls just over 20% of the capital commitment over the course of year one of the investment period, some funds call more than 35%, and some call less than 15%. Distributions are even more variable because in good return outcomes, funds may distribute multiples of the original commitment. The median buyout fund returns about 15% of committed capital in year six, whereas top-quartile funds return more than 30%. These charts show how varied the potential cash flow outcomes can be for any given fund.

Annual Capital Calls as % of Commitment[1]



Annual Distributions as % of Commitment[1]



The inconsistent and unpredictable nature of the cash flows means that overly *conservative* commitment pacing can lead to falling short of a desired portfolio allocation. A shortfall can limit the benefits of investing in private assets and lead to inefficient portfolio construction.

On the other hand, *aggressive* commitment pacing introduces liquidity risk. A few years of overzealous allocations can lead to higher-than-intended allocations, especially in times of market volatility, which ties up capital. This can strain the ability to use a portfolio to fund consumption, philanthropy, or other spending goals. A liquidity crunch not only complicates portfolio management but can also force suboptimal decisions, such as the premature sale of assets or an inability to capitalize on new investment opportunities.

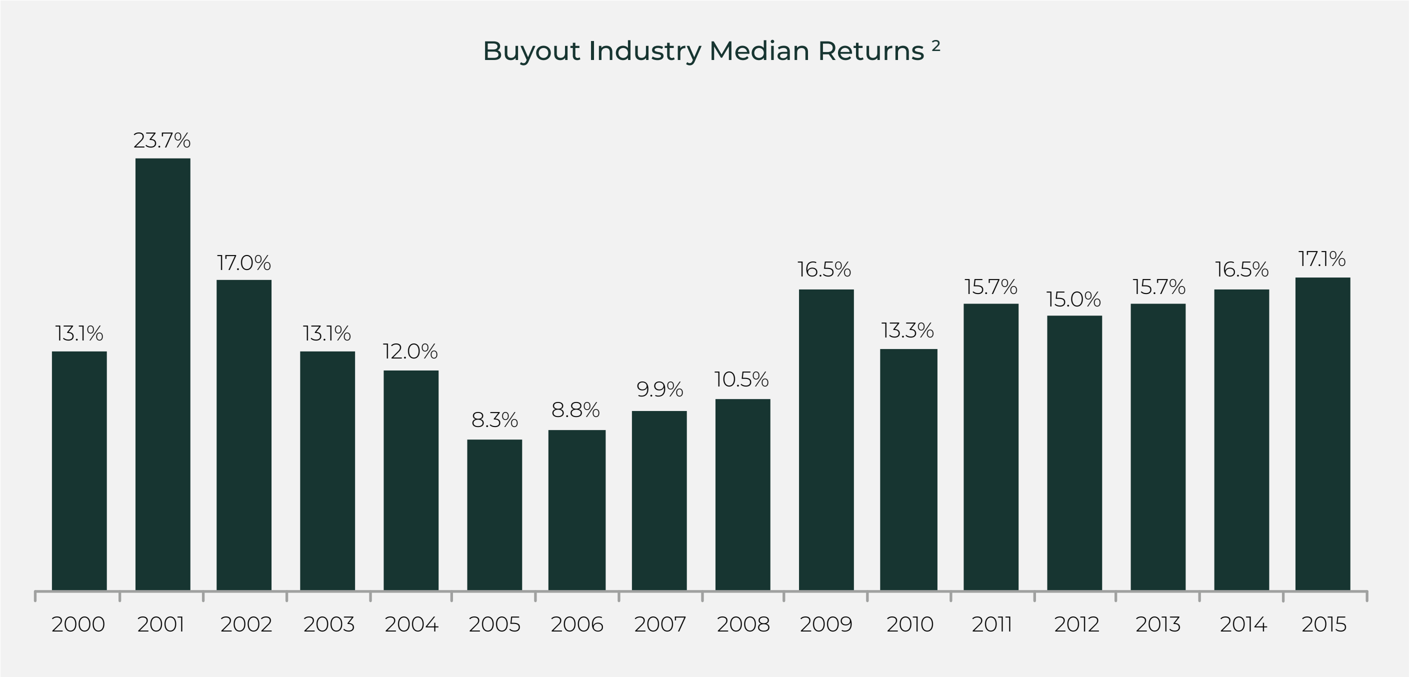
Therefore, striking the right balance with commitment pacing is a fundamental aspect of safeguarding the portfolio against the dual risks of shortfall and illiquidity.

[1] Burgiss Universe – Annual capital calls and distributions as a percentage of commitment by year for all buyout funds from 2000 through 2023.

The Importance of Pacing

At GEM, we believe a consistent approach to pacing commitments can serve multiple objectives: meeting desired return targets, avoiding market timing pitfalls, managing liquidity, and ensuring balanced vintage year diversification.

To put real numbers around this perspective, consider industry returns across vintage years:



Throughout the 15 years around the Global Financial Crisis (GFC), individual vintage years (defined as the year of the first investment for a fund), have produced median industry returns as low as 8.3% (in 2005) and as high as 23.7% (in 2001). If an investor committed equally every year from 2000 through 2015, and generated median returns consistently, the average return in buyout would have been 14.1%. Committing heavily during good or bad stretches, however, would meaningfully reshape the portfolio's returns.

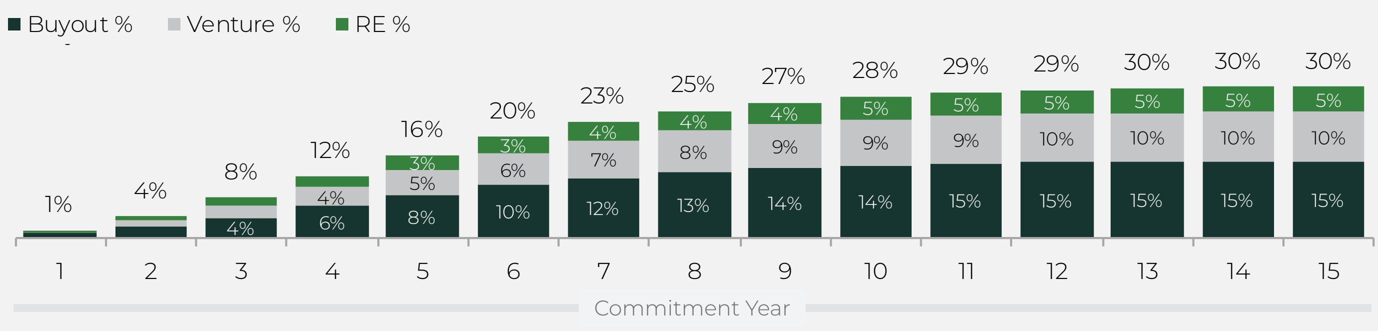
[2] Burgiss Universe - Median buyout returns by vintage year.

Large deviations from set pacing targets can result not only in an unnecessarily idiosyncratic return experience, but also in unintended allocation consequences.

A

Consider a hypothetical example: Investor A, "Thoughtful Investor," is starting with no current exposure to private markets. The investor has $100 million of investable assets and is targeting a long-term allocation of 15% to private equity buyouts, 10% to venture capital, and 5% to real estate for a total private allocation of 30%. Using this example, Investor A followed a consistent pace of 3% per year to buyout to reach their target allocations between years 10 and 15.

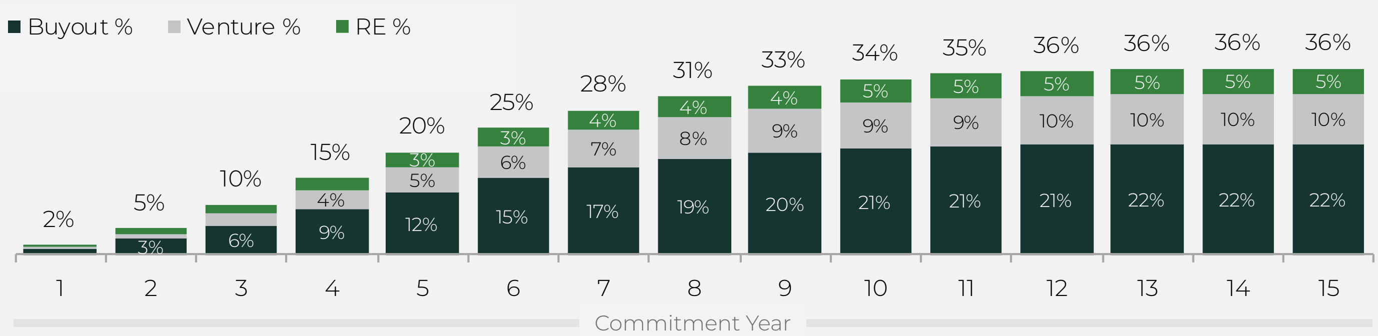
(A) Thoughtful Investor: Private Allocation as % of AUM



B

Alternatively, Investor B, "Aggressive Investor," has the same starting profile as Investor A, but instead commits 5% per year to buyout, hoping to reach the target more quickly. They achieve the initial objective, reaching the target allocation in year six, but by that point it is too late to shut off the spigot. This prior aggressiveness means the rate at which capital is being called is meaningfully outpacing the rate it is being distributed. That causes the portfolio to become overallocated to buyout in years 10-15, and by not reducing the annual commitment percentage at any point, to stay overallocated for a long time. If the liquid portion of Investor B's portfolio sells off in a market downturn, the weight to illiquid investments will go up further and access to liquidity may be strained.

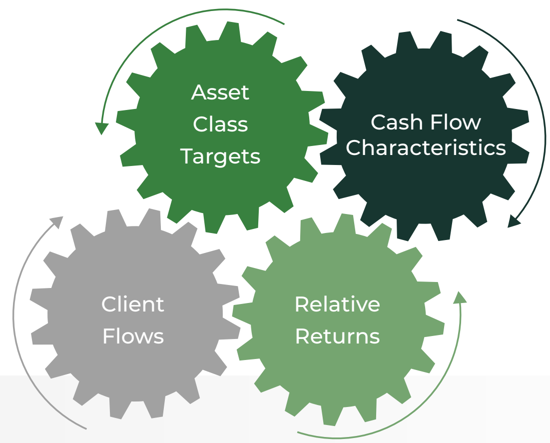
(B) Aggressive Investor: Private Allocation as % of AUM



Mistakes of under- or overallocation are difficult to correct because today's net asset value is from a commitment several years ago. By the time you can see the error, it's too late. Naturally, the question arises: *How do I know how much to commit per year to reach my target allocation?*

Factors Influencing Pacing

Key variables like asset class targets, cash flow characteristics, funding and liquidity needs, and relative return expectations all shape pacing strategies. Factors such as faster capital calls, slower capital distributions, lower returns in traditional asset classes, or higher-than-expected liquidity needs could lead to overallocating. The opposite scenarios could just as easily result in underallocating.



Key questions to consider:

1. What is the appropriate level of equity risk in the portfolio? How much of that allocation should be public versus private?
2. What is the level of conviction that the private investment opportunity can deliver superior results?
3. How much private investment exposure does the portfolio have today? What is the long-term target?
4. How much unfunded obligation (i.e., the remaining obligation to fund preexisting commitments) exists in the portfolio today?
5. What are the potential claims on the assets or spending needs to be drawn from the portfolio?
6. How liquid are the other investments in the portfolio?

The table on the right provides a framework for how to score the answers, which should translate towards either a conservative or aggressive pacing plan.

To put words to the table, if an investor has a high conviction in private investments, is below current target weights, and has limited need for liquidity from the portfolio, the investor can afford to lean more aggressively with pacing. On the other hand, if an investor is already above target private allocations and has low conviction in the opportunity set or expects to spend from the portfolio, then a more conservative commitment approach could be appropriate.

Balancing these factors is often art as much as it is science, and in most cases, the various considerations may be mixed and can shift over time.

GEM Portfolio Pacing Framework

Portfolio Consideration	Conservative Pacing	Aggressive Pacing
Conviction in private opportunity set	Lower conviction	Higher conviction
Current private allocation %	> Target	< Target
Current private unfunded %	> ½ Target	< ½ Target
Portfolio Flows	Expected outflows	Expected inflows
Other assets	Moderate to low liquidity	High liquidity

Pacing in Practice

To elucidate the concept of pacing strategy for target allocations, let us consider a specific scenario. An investor has a multi-asset portfolio with a net asset value of $100 million. The investor and their advisor develop a new strategic asset allocation, which includes a 15% target to private equity buyouts. To effectively navigate toward the target allocation, they apply a systematic pacing model, commonly referred to as "rules-based pacing." The rule for buyouts is that the appropriate annual commitment rate to reach a long-term target is equal to the desired target allocation percentage divided by 4.5. It's worth noting that the actual annual commitments by year will likely vary based on opportunity set and manager fundraise timelines, but the expectation is to adhere to the rule on average.

For this $100 million portfolio aiming for a 15% allocation in buyouts, the rule of 4.5 in this case indicates an *annual commitment rate of 3.3% of the total investable assets*. That translates into an annual commitment of approximately $3.3 million in the first year.

$$\text{Annual Dollar Commitment} = \frac{\text{Target buyout allocation as \% of NAV}}{\text{Pacing rule divisor}} \times \text{Beginning Year NAV}$$

$$\$3{,}300{,}000 = \frac{15\%}{4.5} \times \$100{,}000{,}000$$

While the pacing concept is well known within the institutional community, target allocations and sub-asset class pacing strategies have long been debated. At GEM, we believe that a systematic approach is optimal, so long as it allows for flexibility to adapt to real-world dynamics. The rules-based pacing plan, therefore, is a starting point in devising a pacing strategy and should be continually refined in the light of evolving market scenarios, conversations with clients, and portfolio needs. To that end, GEM typically applies different pacing strategies to sub-asset classes within private investments to accommodate assumptions unique to the sub-asset class, as outlined below. For this portfolio, we might expect the following:

Private Asset Class	Target Allocation as % of AUM	Beginning Target Allocation ($M)	Rule	Annual Commitment as % of AUM	Year 1 Annual Commitment ($M)
Buyout	15.0%	15.0	4.50	3.3%	3.3
Venture	10.0%	10.0	6.00	1.7%	1.7
Real Estate	5.0%	5.0	4.00	1.3%	1.3
Credit	5.0%	5.0	4.00	1.3%	1.3
Natural Resources	5.0%	5.0	7.50	0.7%	0.7
Total	**40.0%**	**$40.0**	**5.10**	**8.2%**	**$8.2**

You'll notice that the rules-based pacing divisor shifts by sub-asset class. That's driven by a combination of return expectations (i.e., more growth in asset values at any given point in time) in conjunction with the weighted average life of a dollar outstanding.

From a risk-return expectation perspective, higher annualized returns are targeted in buyout in comparison to real estate, for example. All else equal, that would lead to slower pacing in buyout to offset the expectation of higher relative growth in asset value at any given point in time. In other words, each dollar of buyout commitment can be expected to make more progress toward a target buyout allocation than each dollar of real estate commitment.

The weighted average life of a dollar (WALD) outstanding refers to the average length of time that each dollar of an investment remains outstanding before it is returned. This metric is meant to capture how long an investor can expect to live with a commitment, or the time between commitment and distribution. That drives how quickly the investor can expect to recycle capital into successive funds.

When comparing asset class expected returns and WALD, we believe venture capital deserves one of the highest pacing divisors, indicative of a longer capital holding period. This approach is strategically aligned with the inherent characteristics of venture capital investments. Venture companies usually undergo extended growth trajectories, and, consequently, the path to a liquidity event or exit is lengthier in comparison to buyout strategies. In contrast, buyout investments often involve a shorter holding period, because the investment generally targets more established companies with predictable cash flows and clearer pathways to value realization. Across the five presented asset classes, real estate tends to have the shortest holding period duration, which tends to require faster pacing to maintain target allocations.

Private Asset Class	WALD Outstanding
Buyout	5.0 Years
Credit	5.0 Years
Natural Resources	8.5 Years
Real Estate	4.7 Years
Venture	6.5 Years

One private asset class we do not list in this table is the secondaries asset class. The acquisition of private investments in the secondaries market is unique because it allows for funds to be purchased at various stages in their life cycle. As such, modeling a specific pacing divisor for secondaries doesn't make sense; however, this asset can play a critical role in building a private investment portfolio from scratch. For investors seeking an accelerated build up for private alternative exposure, the secondaries market can provide a faster ramp up of exposure. Secondaries can be an effective tool in building out a well-diversified private portfolio by vintage year, sector, strategy, and region, but they require custom planning outside of a traditional pacing model.

From an implementation perspective, individual portfolio characteristics should serve as a guideline rather than a rigid framework, acknowledging that the practicalities of market conditions, fund performance, and liquidity considerations can influence the actual pace of commitments. By employing this model, investors and advisors can methodically work toward achieving their targeted allocation, ensuring that commitments are paced in a manner that aligns with the overall investment strategy while also maintaining sufficient liquidity and flexibility to adapt to market changes and investor needs.

Conclusion

Mastering the pacing of annual commitments to reach target allocations in private markets is a nuanced and dynamic endeavor, integral to the success of sophisticated investment portfolios.

Key takeaways investors should consider in their commitment strategies include:

- The need for a consistent, long-term approach.
- Characteristics of the asset classes or sub-asset classes and their influence on cash flow expectations and liquidity.
- The importance of periodic adjustments to align with evolving market conditions and investor objectives.

A rules-based pacing approach, while a robust starting point, is not a one-size-fits-all solution. But by employing the disciplines discussed, investors should be able to effectively navigate the complexities of private investments and achieve their targeted allocations while maintaining their required liquidity and flexibility to capitalize on emerging opportunities.

We believe private investments continue to be an important piece of many investors' allocation puzzle. Beyond just selecting good investments, however, private investing requires some distinct disciplines: sizing investments, managing portfolio liquidity, dealing with capital calls and distributions, and, critically, pacing commitments to reach target allocations.

About GEM

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