DIVERSIFICATION, ACCESS & FEES:

Trade-Offs in Private Capital Investment

Life is full of trade-offs — and investing is no different. Balentine navigates these trade-offs for our clients in multiple ways, and accessing private capital is one of them. When considering private capital investments, which are the equity and debt of private companies and real assets, Balentine acknowledges the following three trade-offs: diversification, access, and fees.

Diversification in private capital is advantageous in tightening the cone of outcomes. Consider venture capital. According to a 2012 Harvard Business School study, 75% of venture companies fail. This begs the question: Why would anyone invest? The answer is the benefit received from the 25% of venture companies that do succeed typically outweighs the losses from the 75% that fail. Investors need to consider this asymmetry of outcomes when approaching the asset class. Would they prefer rolling the dice on one venture company, or would it be prudent to invest in 20 or even 100 of these companies to make the outcome non-binary?

As for **access**, success begets success. Private capital managers who have long track records of performing well are often brought the best deals and their funds are often closed to new investors. It is not a coincidence that the general partners who helped grow companies like Apple, eBay, and Facebook are still relevant and performing well today. It is also not a coincidence that there is not a “Click Here To Invest” button for the general public on their websites.

This leads to another parallel truth: There is no such thing as a free lunch. Investors who seek diversification and access will have to pay for it with an additional layer of **fees**. These trade-offs are evident when one considers the four main ways to access private capital, ordered from lowest diversification and fees to highest diversification and fees in Figure 1.

1. Fund of funds

a. For an additional layer of fees, investors can commit to a fund manager who then turns around and commits to a number of other fund managers. This creates diversification as it would take multiple funds failing for the investor to lose money.

b. Ideally, the fund of funds manager has access to the best fund managers who typically are capacity constrained and not easily accessed by the average investor.

c. The goal is that the top-level access and diversification are worth the trade-off of paying higher fees.

2. Direct funds

a. Investors can forgo the additional layer of fees, diversification, and access fund of funds provide by investing directly into one fund. A certain level of diversification still exists as a fund will typically invest in 10–20 assets.

b. The goal here is that individual fund managers can outperform the fund of funds through fewer fees and a more concentrated approach. The downside is that the investor can be exposed to negative outcomes in the case that one manager fails to perform.

3. Co-investments

a. Moving beyond funds, investors can invest in deals alongside the fund managers who have additional capacity for companies or assets. This occurs when managers are at the end of the investment period and lack the dry powder to invest fully, or if the check they need to write is oversized for their fund.

b. Often in private equity (less so in venture), these deals can exclude management and performance fees, which represent an advantageous way for investors to dial up their private exposure.

c. The other advantage is the company or asset is fully managed by the general partner of the investment, who is typically well-aligned to deliver a good outcome.

4. Direct Deals

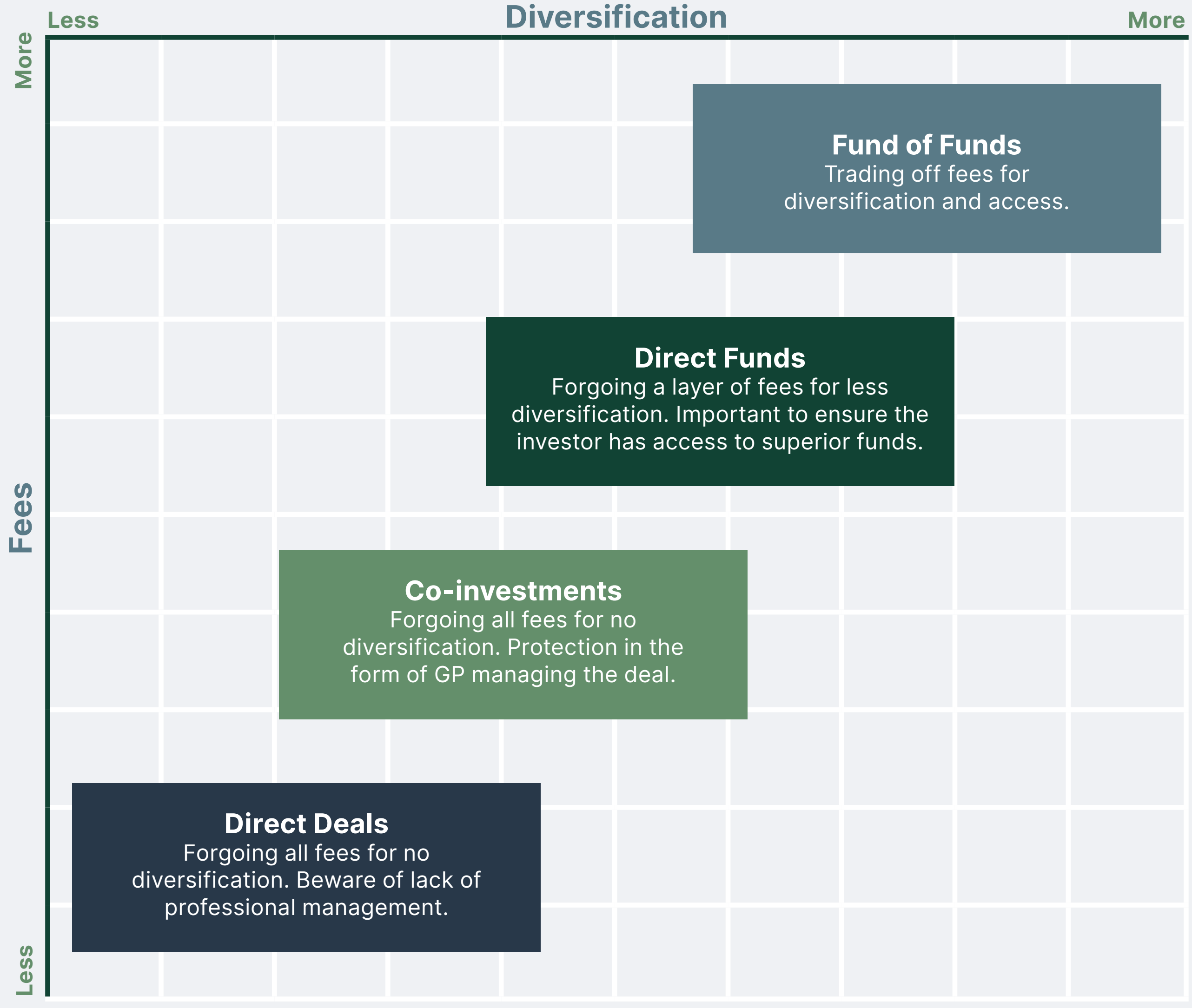
a. Direct deals are one-off investments that are typically sourced from an investor's network or family or are presented to Balentine by so-called "fundless sponsors," knowledgeable individuals looking for opportunities who do not have a committed fund. On the surface, they look like co-investments, but require two additional considerations:

   i. Who is managing the asset? General partners will typically take board seats or have control of the asset in fund investments. If an investor is passive in the company or asset, they are relying heavily on the management team of the asset to execute.

   ii. Why is this deal being shown? There could be a reason no fund manager wanted to do the deal or buy the asset. It is crucial to understand why — and how — the deal has made it into the investor's view.

Both co-investment and direct deals land on the far end of the spectrum of diversification. While fees may be low, diversification is non-existent. A failure of the company or asset represents 100% failure in the investment.

Figure 1: Accessing private capital is a trade-off between diversification and fees



Weighing the Trade-Offs

When considering private investments for clients, Balentine seeks a balance in these trade-offs. To gain broad access to an asset class, we will use the fund of funds model. This allows one check from an investor to be diversified across multiple sub-asset classes, vintages, and stages of funds. This tends to be an investor's first, and sometimes only, investment. This increases the chance the cone of outcomes is narrow and the extra layer of fees is worth the diversification.

Another area where we use the fund of funds model is in venture capital. With many of the top quartile managers closed to new investors, the fund of funds model is our attempt to gain access to the next wave of world-changing companies.

Once an investor has a solid and diversified core, Balentine then employs direct funds to sharpen access to private equity, real assets, and debt. We look for managers who are investing on one of our four intergenerational themes[1] and have a material track record of doing so. We lean on our experience and process to mitigate the risk of higher concentration as well as our long-standing relationships in the market to gain access to high-performing managers.

In an attempt to deliver even further concentration and return, Balentine will seek to co-invest with our managers in the deals in which they have capacity. This brings down the overall fee of the full investment and gears clients' portfolios toward the potential high-return companies or assets. We prefer this method over direct investments, as we can lean on the general partner's expertise and alignment to move the company or asset along its needed path. This is not to say we will not recommend direct investments that are not co-investments, but the bar will be high.

In search of optimizing these trade-offs, Balentine creates investment structures that allow our clients to receive the best of diversification, access, and fees. This structure allows us to invest capital across multiple funds and co-investments without the additional management fees that fund of funds charge. This will also broaden the landscape of funds available to our clients as some hard-to-access managers require high minimums to invest. Our most recent fund was created to access the decarbonization of our energy stack theme. In 2023, we will launch another structure to take advantage of the opportunities we see in the credit markets.

Navigating the trade-offs that exist in the private capital markets can be the difference between a favorable and unfavorable outcome. Balentine's experience allows us to understand when to ask clients to pay for diversification and access as well as when to accept concentration and risk. We appreciate he trust our clients place in our judgment as we seek to be discerning in a world of scarcity.

[1] *See Capital Markets Forecast 2022 for more detail.*

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