KEYNOTE INTERVIEW

How passive index investing could disrupt PE

Index funds that passively invest in private funds have the potential to outperform portfolios of individually selected private funds, similar to how passive has beaten active in public markets, say NewVest's Edward Talmor-Gera and Ariel Ezrahi

Q What do we mean by passive investing in the context of private markets?

Edward Talmor-Gera: In public markets, you have stock picking. You have active management through hedge funds and mutual funds. Then there is the broad universe of passive ETFs and index funds, which now represent more than 50 percent of public market investments globally. Private markets operate in a similar fashion, with the equivalent of stock picking being the selection of individual funds.

You also have active management through funds of funds and secondaries funds, where fund managers choose individual funds, similar to the selection of individual securities by mutual fund and hedge fund managers. But there has been a big gap in the private markets, with no way to get direct exposure to the private markets in a low cost, low risk, diversified and, most importantly, passive manner. This is the gap we are addressing.

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Q What do you index against and why does this make sense?

ETG: We believe pooled returns represent the most appropriate measuring stick. Private markets performance has historically been benchmarked against median returns due to a lack of reliable performance data. However, private markets data has improved significantly, to the point where we now have more confidence in cashflow-weighted average returns, which are considered by many private market professionals a truer reflection of what private equity as an industry is offering.

Our research has shown that private equity pooled net returns have historically been more attractive than median net returns since 2000. Median

net returns per vintage since 2000 have averaged approximately a 1.5x multiple on invested capital, while top performers have generated more than 2x. These top performers have pulled pooled returns above the median, in some vintages by a significant margin.

Pooled returns have exhibited meaningfully lower volatility over time than investing in a handful of funds. Since 2000, the worst year for private equity saw pooled returns generate money multiples of 1.55x and a net IRR of around 7 percent. Pooled returns in the best vintage years generated money multiples greater than 2.3x and net IRRs in the mid-to-high-twenties, with the average for the period 2000-2020 being a money multiple of around 1.8x and net IRR of 18 percent.

We analysed LPs with publicly available trailing 10-year PE returns since 2010 and found that just one had outperformed the private equity benchmark consistently each year. Why? Because over this time period approximately 25-35 percent of funds outperformed the pooled return each year – meaning 65-75 percent had underperformed. With those odds repeated yearly over a decade of portfolio construction of private equity funds, statistically, the chance of beating the pooled return consistently is low, which is why it is so difficult for private equity LPs to outperform.

Q What index products are you offering?

ETG: We launched our first two index funds last year, one for private equity and one for private debt – the first investable, passively constructed private markets index funds available to investors. This year we launched the second iteration of those product lines, alongside a third product, which is focused on energy transition infrastructure funds.

Over time, we intend to create annual products for each of the core asset classes – private equity, private debt, infrastructure and real estate – alongside niche indexes focused on distinct sectors, geographies and themes within the private markets. We also plan to introduce products that reach further down into the market, such as small- and mid-cap private equity funds, similar to the FTSE 250 and FTSE 100, as well as levered indexes. We are not looking to reinvent the wheel but rather to replicate in private markets that which we have seen to be so successful in public markets.

Q What was the thinking behind the energy transition fund?

Ariel Ezrahi: Climate change is considered by many to be the biggest challenge facing humanity. An estimated $3 trillion-$5 trillion needs to be mobilised annually to address that threat. Our index fund was launched at COP28 and is targeting investments in 28 of the largest funds raising private infrastructure capital this year to support the energy transition. We expect our index will capture more than 90 percent of this year's fundraising in this segment.

Since it is quite challenging to know with certainty which funds are going to be the most successful disruptors, by targeting 28 of the largest funds in this segment – designed to provide broad exposure to the vast majority of the market – we believe we have a better chance (compared to selecting a small number of individual funds and hoping for the best) to gain exposure to the companies that ultimately crack the code when it comes to battery storage, green hydrogen and other innovations we need to successfully transition.

Q How do you ensure access to these funds?

ETG: That was, undoubtedly, the biggest perceived challenge. However, when constructing our inaugural private equity index, only one manager of the 50 largest funds we were targeting did not give us access.

More than 600 GPs raising more than 1,800 funds last year between them understood our strategy – recognising that our passive approach would make us an 'easy LP'. For example, we don't require them to complete 100-page DDQs, and we don't need to meet the founder or interrogate them about a deal that went wrong 10 years ago. All we ask is that we are given institutional access, without any feeders, and that we receive the standard fee rate. We also sold the vision of what passive investing could do for private markets in terms of growing the pie for everyone and making the democratisation story more viable. Ultimately, this proved to be a winning pitch.

Q What are the target markets for these products?

ETG: There are three main categories of potential clients. The first is the classic institutional investor that is already investing in private markets. We believe there is room for those investors to anchor their private markets programmes in a complementary manner with our private equity and/or private debt index funds and then have more time to enhance their focus on alpha generating strategies. Those same investors may use our niche index funds, such as energy transition, to invest in markets and segments where they don't have the depth of reach and in-house expertise.

The challenge we face is the same as that faced by passive instruments in the public markets in the 1980s and 1990s. Such investors may feel they are doing themselves out of a job or that focusing on the pooled return may highlight issues with their historical track record. That is not a comfortable position for them, and it is a challenge for us.

The second segment is comprised of investors that are just starting out in private markets, as well as investors that have a combined public and private markets team rather than dedicated private equity or private debt investment professionals. We see these investors as more likely to be earlier adopters, as most are already familiar with index investing through their activities in public markets, and they should not feel their jobs are threatened. We therefore believe these investors would see us as a more efficient, lower-cost substitute to investing through funds of funds.

The third category is one we are being pulled into, rather than one we are actively targeting. It revolves around the push by private wealth platforms and their clients on the one hand, and private fund sponsors on the other, to 'democratise' private markets. This is not something we are doing ourselves, but we believe we can be a meaningful enabler of better democratisation for those businesses that are focused on last mile distribution to retail and private wealth investors.

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EDWARD TALMOR-GERA

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My concern as things currently stand is that funds offering 'access' to these investors represents a small slice of the overall market, so access is being adversely curated. That is a huge risk for all of us, because it only takes one of these access products to perform poorly, or worse, to attract the unwanted attention of regulators – and then it could be game-over for the democratisation trend.

At the end of the day, we believe passive indexing will be a positive development for the industry.

Q How do the indexes work from a structural perspective?

ETG: Legally, we operate a typical closed-end, non-listed, drawdown, fund of funds structure. Investors have the option of not paying any management fee and only paying a carry of between 2 and 6 percent (commitment size dependent), using a European waterfall mechanism to minimise the impact on net IRRs. We believe this economic arrangement can significantly reduce the gross-to-net spread.

We operate an annual programme. For our core products we generally target investments in 50 of the largest funds in a single asset class (based on their stated target capitalisation) raising capital each year. Just as the S&P 500 is considered to be a good proxy for all equities, we believe the 50 largest private equity funds are a proxy for the private equity asset class as a whole, typically representing over 70 percent of all private equity capital raised each year. The broad diversification has the potential benefit of lower volatility and lower risk, and there are operational efficiency benefits too. ■

Edward Talmor-Gera is chief executive at NewVest, a tech-enabled platform of index funds for private markets, and Ariel Ezrahi is director of climate strategy at the firm