Bryan Jenkins & Eric Solfisburg

Episode 256: Best Practices for Portfolio Construction in Private Assets

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. My name's Stewart Foley. I'll be your host. Thanks for joining us. We've got a great podcast for you today. The topic is best practices for portfolio construction in private assets. And we're joined by two folks from Hamilton Lane, Bryan Jenkins and Eric Solfisburg. Guys, thanks for coming on, thanks for taking the time. There's lots to discuss here. And one of us has a little history together, so welcome. Welcome to the podcast.

Bryan: Thanks for having us, Stewart.

Eric: Yeah, good to here.

Stewart: Bryan, you are a head of portfolio strategy and research, and Eric Solfisburg, CFA, CAIA, CLU, CHFC, principal and insurance strategist at Hamilton Lane. And before we get going too far, Eric and I used to work together back when the earth was cooling, so we have a little bit of history together. But I don't know the answer to the following two questions, which is where did you grow up and what was your first job, not the fancy one? And then we're going to come to you, Bryan, and ask you the same thing.

Eric: So I grew up on Boston's South Shore in Duxbury, in Milton. And my first job, not the fancy one, well, right out of school I started as an entry-level analyst at a OCIO, an investment consultant that you made your way to and then went on to build InsuranceAUM off of. So that's where I started out and that's where I got my start working with insurers and got into the fun and weird, strange world that is insurance asset management.

Stewart: Absolutely. Bryan, how about you? Where'd you grow up and what was your first job, not the fancy one?

Bryan: So I grew up in Bucks County, Pennsylvania, which is just north of Philadelphia. Probably most famous for producing the singer Pink and being the most hotly contested county in this presidential election which, thank God, can't be over soon enough. My first job, which I remember well because my mother took me there the day I turned 14, which is the legal working age in Pennsylvania, it was bussing tables at a local restaurant. So I think she was just happy to get one of her three boys out of the house for a few more hours a week.

Stewart: I like that idea. It is interesting how when you're bussing tables at a restaurant, that's a humble start, right? I mean, it just is. And I think it's character building. I started mowing lawn when I was a little kid. But when you're at McDonald's and in that rust-colored uniform with the paper hat on, and your friends from high school walk in and you're just like, "This isn't going to get any better. This is not good. This is not the image that I want portraying me."

Bryan: It was a good job. But you can put me firmly in the camp of believing that everyone should work a service industry job at some point in their life.

Stewart: Absolutely. And you know what, I honestly... I mean, I was proud of my time at McDonald's. I really was. I learned a lot. I had really good colleagues. And I learned this statistic. One in eight people in the United States worked at McDonald's at some point, which is an astonishing statistic, I think. But let's get to the business at hand here. I want to talk a little bit about defining portfolio construction and what makes that important in the context of a private asset portfolio. But I also want to get a little bit of background on Hamilton Lane, just in case there's people who don't know what you do. If you can give us a 30,000-foot overview of Hamilton Lane, and then let's talk about portfolio construction with private assets.

Bryan: Yeah, sure. So Hamilton Lane, we like to think of ourselves as one of the largest investors in the private capital space ,globally. So we're approaching about a trillion dollars of AUM and AUA. We've been investing in private markets for over 30 years now, so long enough to have a midlife crisis and get a tattoo and start maybe... join you on one of those motorcycle trips that you've done.

Stewart: I was going to say, I've done both of those, tattoos and motorcycle trips, both. So perfect.

Bryan: There you go.

Stewart: Yeah.

Bryan: Private markets is all we do, and we do all flavors of private asset investing. So everything from private equity to credit to infrastructure and real estate, secondaries, co-investing, semi-liquid solutions. We do it all. And we've been servicing insurance clients for a very long time.

Eric: Yeah. So insurance is actually a meaningful portion of our business, representing about 10% of our assets under management and advisory. So it's an important and growing segment of our business as well.

Stewart: Yeah. I mean definitely, I think, the insurance asset management market is white-hot right now. And insurers, as folks who are unfamiliar soon find out, it's a very sophisticated audience that has a myriad of externalities to deal with that aren't the case for most institutional investor types. So you've got to bring your A-game into the insurance business for sure. So let's go back to the question I started with. Talk a little bit about defining portfolio construction and the importance of it with private assets.

Bryan: So, we'll start with the definition. And I think of portfolio construction as really any decision that impacts portfolio outcomes outside of the pure asset diligence and investment selection. All of the cool kids are spending their time picking deals and evaluating companies, but there are a whole host of other decisions that need to make when building a private asset portfolio. So, asset allocation or strategy allocation is the most prominent, most obvious. But it also includes some other choices like how we build that exposure over time, how do we make pacing decisions, how do we think about the liquidity and model that, what are the right mechanisms for accessing exposures?

And then a critical assessment of the performance, of the risks that you're taking, about what's driving returns, and periodic adjustment of your portfolio strategy. So I think of portfolio construction a little bit like being the bassist in a band. The lead singers, the Dio people who get all the shine. But without the bassist, the band doesn't really work. It's just going to sound off.

Stewart: That's super interesting. And I think it's consistent with the research that has been done over time that we've all learned about asset allocation, right? If you're in the right sectors, that's a really important decision. Do you have any insights on why portfolio construction has become a secondary focus for some investors as opposed to starting there?

Bryan: Well, I think it's part practical and part behavioral. And so maybe with the behavioral part is that it's just much cooler to talk about the latest deal or fund you did and how unique and awesome it is. It's much more fun for all of those freshly minted MBAs to talk about TAMs and fragmented markets and playbooks and M&A growth engines than it is to talk about how we estimate risk and illiquidity premiums. So that is sort of the behavioral piece. I think the practical piece is that 20 years ago, that sort of deal selection was all that mattered. The industry was just a couple of flavors. And it really was about just picking the right managers and deals within primarily a private equity universe. But this asset class has grown a lot from a couple of trillion dollars of AUM in 2010 to now over $12 trillion of AUM, as of today.

And there's just been an explosion in the number of managers available, the types of strategies, the ways to access private markets. So it's no longer just about that. But I also think there's a realization that, Stewart, just as you alluded to, that this can really drive a chunk of your benchmark relative return. And now we actually have the data and the information to be able to make informed strategy decisions. So to be very thoughtful about portfolio strategy, you need a source of high quality reliable data. And for all of the good parts of this asset class, data and transparency is not one of them. We've been making strides, but this has probably been one of the most challenging asset classes for data and transparency. So we at Hamilton, we've been fortunate because of our size and position and data focus that we've overcome those, but it's been challenging to overcome with commercially available tools and data.

Stewart: And so, I think sometimes people benefit from case studies and things that... kind of looking at examples. So do you have anything that can illustrate some of the portfolio construction mistakes that you've seen and how LPs sometimes can shoot themselves in the foot, for lack of a better term?

Bryan: Yeah. There's a few things that come to mind that, first and foremost, is what I would call LPs, taking the Dallas Cowboys' approach to team building, which is just buying a whole bunch of expensive stuff, that's a collection of what seems like talented individuals, but when you put them together, it's not really a coherent team-building strategy. So that lack of a coherent strategic plan is probably the number one pitfall that I see. Especially if there's sort of limited independent assessment and verification of what to expect from the different strategies or different components of the portfolio. If you just listen to some of the marketing spin that is out there, you're going to have a very different set of expectations than what the empirical data would suggest that you have. So that's a big one.

I would say inconsistent investment pacing is another one. So it's either folks trying to time the market or making the classic mistake that a lot of institutional investors look down on retail investors for, which is buying high and selling low. And so having some sort of consistent investment strategy makes your exposure management, your liquidity management much easier, much more practical to manage. And then the last piece, and I'm sure Eric has a couple as well, is what I'll call transaction tourism. So this is for LPs that were primary fund investors that are starting to dabble in co-investing or direct investing in secondaries, but aren't really considering how those deals fit with the rest of the portfolio and might modify the risk profile of the portfolio.

Eric: Yeah, I think it's also important to consider how specifically insurance investors started to get into this space. I mean, insurers have been invested in buyout and growth for a relatively long time, specifically at the larger end of the market. But it's generally been... We got approval at the board to start doing alternatives. And it's being done off the side of some guy's desk who's really... Or they hired one person to lead an effort. Where it's always played second fiddle to what's going on on the credit side of the portfolio that's the bulk of the assets and is the bulk of the way that insurers think about managing those assets. So there's been a growing sophistication here with insurers building out teams and building out capabilities. But to Bryan's point here, sometimes they look to grow those a little bit faster than they might if they'd taken a really blank-sheet-of-paper strategic approach to it.

Stewart: What about analytics? When you buy data from NAIC or whatever, and you get all the QCIPs of all the holdings of the carriers, that doesn't do you a whole lot of good without some pretty good analytics. Are the analytics that you're using to build portfolios... How much of that is commercially available and how much of it is proprietary, and is it available to... Can I get a subscription to the data, as an example?

Bryan: Yeah, we try to make as much of what we do internally available to our clients and our partners. The story you alluded to, it's not just the data. Data ultimately becomes a commodity. Our view has long been that that will become the case in private markets. We've been perhaps a little bit surprised at how slow it's been for that data to get commoditized. There's been a few very high profile, very expensive sales of private equity data providers. So you could see just how valuable that data is, and so not totally commoditized yet. But the real value is unlocking the insights that are hidden in that data, and that's where the analytics come in.

And so my team has long been focused on developing analytics and tools to make better portfolio construction decisions, whether it's cashflow forecasting tools or benchmarking tools or attribution analysis tools, risk tools. Part of what we've done with our Cobalt platform is to try to take the tools and the data that were previously just within the walls of Hamilton Lane and make them more accessible to our clients, our prospects, and make it more commercially available to the industry, because ultimately it makes the industry smarter.

Eric: Yeah, I mean in my former role at an insurer, I would subscribe to so many different data platforms and vendors. But it was a real question mark as to how complete is the data set, how reliable and clean is the data set? And can I stitch together all of these various data sets to create a more comprehensive view of what's out there? And that's a really involved process that doesn't get you all the way. So I think one of the things that's been attractive about what we're doing here is that we've been really intentional about building out that data as part of our value proposition from day one. And then Bryan's team is expert at taking that data and driving insights from it.

Stewart: It's interesting to me that... And I've kind of halfway been down this path. But industry exposure in a private assets portfolio, I mean it seems like that's an important thing to know. But it's very difficult to look at Schedule BA data and figure out what a particular company's industry exposure is. I mean, one of the things that happens in insurance... And I am admittedly an insurance nerd. But when an insurer basically gets paid to take risk on both sides of the balance sheet, right? I mean, they get paid to... They're making promises to people that say, "If anything bad happens, we'll cover it." And then on the other side of the coin, they're taking risk on the asset side, both side. But what economic forces and industry forces they're exposed to on the liability side of the book, it doesn't seem to always make the translation or transition into risk management on the asset side of the book. What have you seen there? Do you care about industry exposure? How do you think about that in terms of portfolio construction?

Bryan: Yeah, absolutely, we care about it. And Stewart, you're absolutely right that it is a major pain to get that data. And a lot of groups, because it's such a challenge, are just not even reporting on it. Because it's in PDFs or Word docs that are being sent to you. And if you're a large investor with a number of different fund holdings, you can start to do the math on how many thousands of positions that you might have to try to aggregate. And so we're fortunate, we have reporting tools. We partner with technology groups like Canoe that help us be a little bit more efficient about how we scrape that data out of PDFs and aggregate it so it's actually usable.

So that's a big part of our strategy is that tech-enabled, AI-enabled type tools that help us get that data faster. Then from a portfolio strategy standpoint, it absolutely matters. And I would say it matters not just what's in your portfolio, but also understanding what's in the benchmark that you're using. So you have to have transparency not just into your portfolio, but if you're using a peer benchmark, what the holdings are there. Because ultimately, the way that, if you're a private equity team, you're being evaluated is your performance relative to the benchmark, the risks that you're taking to get there relative to your benchmark? And so that's what you really need to focus on.

Stewart: That's the sort of stuff that I think is sometimes not obvious to the LP community, is like what's involved in coming up with a relatively simple question. Which is, "What's the industry exposure across my private asset book?" And you go, "Well, that's a great question, but it's not easy to get there."

Bryan: Yeah. Or even if you know, is that 30% exposure to technology, is that overweight or underweight? And then, that is going to influence how you make that next investment.

Stewart: Yeah. It's super cool. I appreciate that. So can you talk a little bit about a foundation and key tenants for portfolio construction there at Hamilton Lane?

Bryan: Yeah. And this might sound a little basic, but there's really three building blocks to portfolio construction, and those are return, and risk, and liquidity. These are the attributes that you need to quantify about every strategy or investment type or every deal to make informed strategy decisions. And so, that really sets the baseline for our asset allocation framework. In most other asset classes, it's like, "Okay, I'm going to go out there and buy exposure to those risk factors." And it can be done cheaply, efficiently, and relatively quickly. That's not the case in private markets.

We need to figure out how to actually implement those allocations, how to build that exposure over time. We mentioned a little earlier that inconsistent investment pacing and inconsistent approach is a huge pitfall. So we generally believe that a consistent approach, investing a relatively constant amount each year yields the best experience. But there are obviously cases where we need to deviate from that. You can't wait 10 years to build up an exposure. And there are different types of tools, like secondaries, like direct investing that can help us get there a little bit quicker.

Eric: And one of the things that's a key consideration here, insurance investors are born and raised to understand that diversification is one of the few free lunches in investing. So the way that you very intentionally build out that your diversification and have the underlying data to prove that out within a private asset portfolio is really important. Because yes, you can take your time to get into something, but how concentrated is your exposure while you're doing that? And I think that you've got to go into that heads up and always have a lens.

You diversify your risks on the liability side. You've always diversified your risks on the credit side. But how are you diversifying the various risks that you're taking on the private assets side, whether it's sourcing or underwriting thesis, or ultimately sector exposure, geography exposure, asset class exposure? Making sure that you're approaching that diversification with the same intentionality that you do with every other part of being an insurer.

Stewart: I think that the tricky part for a lot of insurers is what's the right amount of liquidity risk to be taken? Because clearly, liquidity has a cost. Super liquid assets do not return the same as illiquid assets. And a lot of insurance companies for a long time have been way over liquid. I think we know that. And you've got Federal Home Loan Bank and there's other ways to get liquidity in the portfolio. How are you having those conversations? And it varies depending upon lines of business and all that stuff, that there's a lot to it. But what kind of conversations have you been having with regard to liquidity with insurance companies with regard to private assets?

Eric: So generally, insurers are... As you mentioned, generally they've been overexposed to liquidity. And so as they're constantly trying to solve the problem to... If you've got product pricing on one side, product expectations on the other, the three ways that you solve that are going to be your investment returns, your lapse experience, and time. And I think that they're going to try and eke more and more out of those investment returns. And giving up some liquidity to achieve that marginal return is something we're only going to see more of. I mean, illiquidity risk and complexity risk are two of the risks that live best on an insurer's balance sheet. And there's been a lot of insurers that have kind of been under-optimized from that lens.

Stewart: That's super helpful. That's one special portfolio consideration for insurance investors. What are some of the others that you come in in the conversations that you're having? What other things come up that are unique to the insurance community?

Eric: So Bryan's talked a lot about the asset allocation and how you build that and how you're intentional about that. But I think that for insurers, asset location is also another really important variable that I don't think gets as much play as it probably should. After you've constructed this optimal portfolio, where's the best place to access that portfolio, from an RBC, tax, product, entity perspective? This is where insurers can have really unique considerations. And each one will be different in the way that they think about segmentation, the way that they think about lining up assets relative to specific product blocks.

But also thinking about if you're a multi-line, there's a lot of multi-lines that don't really leverage the additional degrees of freedom that having a P&C and a life balance sheet allow them. Or if you have a capitalized holdco or if you have onshore and offshore entities, or if you have reinsurance on a funds withheld basis, there's all of these tools on an asset location perspective that I think there's value to be extracted from using those intentionally.

Stewart: That's super helpful. On our key takeaways here, as we wrap, can you summarize some best practices for portfolio construction that our audience can... pearls of wisdom that people can take with them?

Bryan: Yeah. So I would say three things. The first is just have a plan. The portfolio construction, we believe, has a real impact both on the returns, but also how you manage risk in the portfolio. We ultimately think about it as really a risk management function. Because it ensures you have some guardrails so that when your diligence teams are looking at a manager, you are now making an active decision if that commitment to that manager or that deal or that transaction is going to take you outside of your policy weights. So I think just having that plan is very important.

The second would be that recognizing that no individual plan is static, or there should be regular critical evaluation of that plan, or the benchmarking attribution analysis, recognition of what risks are driving the portfolio and whether we want to continue to take those risks or if we need to make adjustments.

And then third is invest in data and your technology infrastructure. You cannot make these decisions in an informed way without the data, so that's important. Having the tools and the analytics to parse that data is important. And then even just within your organization, the ability to share it, to govern that data, and to also make decisions in an efficient way is really critically important to successful portfolio construction.

Stewart: At the risk of being blatantly obvious here, but if I'm a small to medium-sized insurer and I look at this and I go, "This is daunting. It's daunting to go out and assemble the technology." And you go, "Well, okay, where do I start on that project? And by the way, who's going to do it?" So when I go to a Hamilton Lane, you have the analytics that I can access, right? I mean, that's a significant advantage as far as being able to do risk management and due diligence. It seems like that's a real competitive advantage. I mean, have I got that right? Or do people need to do both, invest in the technology and have a Hamilton Lane?

Bryan: We might have to hire you on our business development side with that pitch?

Stewart: Nobody wants that. Nobody wants that.

Bryan: Absolutely an advantage for us. And I think I would say that we find different ways to use that data and technology depending on how our clients want to work with us. So whether that is a full discretionary solution, whether it's a technology-enabled sort of advisory solution where they're getting the data and tools and sort of doing it themselves. We have different ways to work with clients that have different resources or different types of focus on this.

Eric: So we have these front-office technology tools to help insurers and investors make good decisions and then govern those decisions. We also have all the way through to fully outsourced middle and back-office solutions to help investors manage some of the operational complexities and plug into various accounting platforms and things like that to help with the blocking and tackling of what can be a pretty involved process investing in private markets.

Stewart: That's super helpful. I got a couple of fun ones for you out the door. I was just at LSU, talking to a classroom of about 50 people. They were all finance majors. And I think sometimes that when students and people who are earlier in their careers hear people who are senior and successful at firms, I think they often want to know how did you get there. And so if you were coming out of school today with the advent of AI and the changes in markets, and as you mentioned earlier, Bryan, a lot of new asset classes coming to bear, what advice would you give someone earlier in their career today?

Bryan: The advice that I often give to the analysts on our team is to think about your career in a nonlinear sense. So oftentimes you get into a job and think, "I need to become an analyst here, then an associate and a senior associate and vice president," and so on and so on. And that is a very linear career progression. As I look around at the people that have been very successful, both at Hamilton Lane as well as in the industry, they're people that have said yes to a whole bunch of very weird opportunities that fit outside their day-to-day job description. And all of the tools, this new age of AI that you're talking about, Stewart, is going to create a whole bunch of weird opportunities for people that are willing to seize them. And those are the people that are going to be very successful.

Stewart: That's super helpful. Eric, how about you? I think this is an important issue for you. What would you add there?

Eric: Yeah. One of the best pieces of advice I've been given is around looking at where you have gaps and being really proactive in trying to fill those. You might say, "I've got experience or expertise in this area, but not in this other area that could be a way for me to unlock value in what I'm doing or what I may look to do in the future." So if you try to identify what are those gaps on your resume, what are those things that when you go for your next opportunity, whether it's directly related to what you're doing now or not, what are the areas you're going to get knocked for and try to be really proactive about saying, "All right, I'm going to go and fill those in"?

Stewart: That's cool. All right, so final fun one for you. And we got two people, so you guys kind of have to each pick one and agree on one. So we're going to have a table at lunch for five. It's you two and you can invite three guests. Who would you most like to have lunch with, alive or dead? Now, the rules are Eric gets one, Bryan gets one, and then you guys have to agree on one, which that could be... That's interesting. Particularly if we get into sports, given where you're from.
Bryan: I'll give you the first overall pick.

Eric: Okay. So I think my first overall pick probably goes to Kissinger. Because I've read some of his books and I think that the perspective that he would have to offer on the intersection of politics and political systems and economies would just be really insightful.

Stewart: Super cool. How about you, Bryan?

Bryan: So, I'm a Philadelphia guy. I grew up here. I went to school here, I work here, so I gravitate towards great Philadelphians. I'll spare you a sports pick for the first one. I would say Tina Fey would be on the top of my list.

Stewart: Wow, there you go.

Bryan: Native Philadelphian, one of the funniest people on the planet. Incredibly successful. It would be awesome to have dinner with her.

Stewart: Just right there, Henry Kissinger and Tina Fey, that would be an incredible…

Eric: That would be a good one.

Stewart: That's an incredible lunch right there. Just forget about everything else.

Bryan: We have range.

Stewart: All right, so who's the one you agree on? We got one more. Who do you like?

Eric: Why don't you throw out somebody in neutral territory who's not a Patriot or an Eagle?

Bryan: Is a Phillies player acceptable? I named my dog after Chase Utley, so he would be high on my list. I would propose a neutral selection, so we need someone to make this lunch. And so I would propose Michael Solomonov, who owns some of the great restaurants in Philadelphia-

Stewart: Oh, wow. There you go.

Bryan: ... some of the great restaurants in the country in Zahav. And so I need him to teach me how to make his lamb shoulder and hummus properly because I've made them dozens of times and I cannot quite get it right.

Eric: Well, and now you've given me an idea for what... the next time I'm down here at headquarters, what I'm going to do when I'm hungry in the evening.

Stewart: That's perfect. I really have enjoyed having you guys on. I've learned a lot about portfolio construction in the private asset segment as well. So thank you so much for being on, guys. We really appreciate you.

Eric: Thanks for having us.

Bryan: Thanks, Stewart.

Stewart: We've been joined today by Bryan Jenkins, head of portfolio strategy and research, and Eric Solfisburg, CFA, CAIA, CLU, and CHFC, principal and insurance strategist at Hamilton Lane. Thanks for listening. If you have ideas for a podcast, please shoot me a note at stewart@insuranceaum.com. Please rate us, like us, and review us on Apple, Spotify, Google Play, Amazon, or wherever you listen to your favorite shows. My name's Stewart Foley. We'll see you next time on the InsuranceAUM.com podcast.