Improving access to private markets with Bob Long

Michael Venne (MV): [00:00:00] This podcast will cover an investment philosophy that is high risk and considered. Illiquid information regarding the private markets is limited and incomplete. Past performance is not a reliable indicator of future returns. This podcast is only a summary of a complicated investment program.

Over the next five years, private capital assets under management are projected to grow from $10 trillion to $17 trillion, according to a recent report from Morgan Stanley. One of the leading reasons: the individual [00:00:30] investor.

For several decades now, retail investors have watched the composition of stock markets homogenized, skewing towards large cap companies. They've also seen it become dominated by tech companies whose growth was fueled by the low cost of capital and the low rate environment that characterized the global economy between roughly 2008 and 2020. Now, many investors may be willing to accept less diversification if they were getting superior returns, but they haven't.

Between 1987 and June of 2022, private markets as a whole [00:01:00] have outperformed public markets, generating a direct alpha, which compares the return of one thing private markets to a benchmark. The MSCI World Index in this case of 3.9%. Private equity specifically has generated a direct alpha of 5.1%. This is according to Omni, our portfolio management tool. So this desire for better return potential and to gain exposure to a broader swath of companies is driving individual investors toward private markets.

Historically, fund managers targeting [00:01:30] individual investors focused on ultra-high-net worth individuals who can commit hundreds of thousands, if not millions of dollars to a single fund. Obviously, this is out of reach to most people to reduce these barriers to entry. Fund managers have had to solve myriad quandaries in addition to lowering minimums, as managers have had to find ways to allow individual investors to redeem their capital more frequently while finding a less burdensome alternative to K-1 tax reporting.

Today, asset managers StepStone included, offer products that are accessible [00:02:00] by individual investors and their financial advisors. In this episode of RPM, Bob Long, partner and CEO of StepStone Private Wealth, joins me to discuss these products and how they help break down the barriers to accessing the private markets.

MV: Bob, thanks for joining us today. Welcome to RPM.

Bob Long (BL): My pleasure.

MV: Bob, Let's start at the top. What is StepStone Private Wealth?

BL: [00:02:22] StepStone Private wealth is simply the arm of StepStone that's focused on the individual investor and smaller [00:02:30] institutions. We deliver the same content that StepStone has always provided to the world's most sophisticated institutional investors in a structure or package that's optimized for the individual investor. Importantly, what we provide at StepStone Private Wealth is the same investments on the same terms as those offered to institutions, and we do it in a pro rata allocation policy. So this is not a different set of investments or a corner of our business. [00:03:00] It's the same core business of StepStone simply offered in a different package for individual investors. And in terms of our platform, we believe the characteristics that distinguish us are a focus on efficiency, convenience and transparency. And as we'll get into in this discussion, those are characteristics that are really important to the individual investor and have been challenges for that investor in accessing these markets.

MV: [00:03:24] So historically, private markets have outperformed and by some measures [00:03:30] better represented the quote unquote true economy than public markets, which explains why individual investors have long sought to invest in private markets. But what was preventing them from doing so?

BL: [00:03:43] Good question. It's really not news. The challenge, of course, is how do you effectively access these assets? And it comes back to convenience, efficiency and transparency, which we previously touched on. Think out, organize our conversation around two themes, two types of barriers. [00:04:00]

The first are investment strategy and the second are structure. So on the investment strategy side, individuals historically could not access the best managers in transactions and given the wide dispersion of returns in the private markets. In fact, that's arguably a defining characteristic of the private markets. If you can't access the best managers, you probably shouldn't be in the private markets. Let me be more specific. If you look at a large cap public equity manager in the US, [00:04:30] the difference between the bottom 25%, which we call the bottom quartile and the top quartile top 25%, the difference in returns historically has been something like two, two- and one-half percent. The difference between eight and ten- and one-half percent return meaningful, certainly not life change. In the private markets, the difference between the top quartile and the bottom quartile is often 20%. So that illustrates my point. In the private [00:05:00] markets, you need to be with the top managers. In the best transactions. There's been limited access for individual investors to truly institutional caliber strategy. So in many cases the products have focused on the investments and transactions that institutions didn't speak for. The leftovers, if you will, and other cases.

BL: [00:05:21] The allocation policy has not been on a pro rata basis. This is really central to what we do and how StepStone Private Wealth works with the bigger StepStone [00:05:30] and all of our products. Investments are allocated pro rata. The StepStone Private Wealth products are simply another client alongside StepStone has about 120 or 150 large institutional clients. Today we're just another client getting allocated the same deals on a pro rata basis. That's really important. Other thing about the private markets versus the public publics, of course, and have moved toward an open architecture approach. In fact, asset management, broadly defined, has moved inexorably toward an open architecture [00:06:00] approach, getting away from proprietary products. Private markets have been behind in that regard, meaning many of the products have been a closed architecture focused on deals generated by one manager or one strategy and finally, yield oriented products. Most of the private market products were oriented around yield, so they were real estate or credit oriented. Now, if I could, I'll move on to structure. These transactions, Actually, I think we need to to provide a little education here. The typical private market product is an investment in [00:06:30] a a new fund, what we call a primary fund. And primary funds generally exhibit a J curve phenomenon. This is the tendency to deliver negative returns and negative cash flows in the early years. So it goes down before it goes up, and hence it's called a J-curve. Moreover, the fund has a drawdown structure where you commit an investor commits to a fund, that capital is drawn, his capital is drawn over time, typically on an unpredictable basis, and then returned to him on an unpredictable basis, [00:07:00] makes it really hard to maintain an asset allocation.

BL: [00:07:03] Moreover, from first cash flow to last cash flow, even though these funds are advertised at ten- or 12-year funds first cash flow, the last cash flow is often significantly longer than that. I've seen studies indicating that averages 15 years. That's a really long time for an individual investor. Minimums are high, as Michael described at the beginning. In fact, I'd say some of the lowest minimums we see for these products are 250,000, and often they're as high as $5 million. And then [00:07:30] you get to the fees charged. Historically, there's been a significant premium paid by individual investors in comparison to institutional investors. And last but not least, the dreaded K-1. So when you own a mutual fund or a stock or have a brokerage account, you get a 1099 in January explaining your tax consequences for the prior year. At a private fund typically organized as a partnership, you receive a Schedule K-1and you don't receive it until October. So [00:08:00] you have to amend and delay your tax filing. So there are just a lot of reasons why the private market benefits have been hard to access for individual investors.

MV: [00:08:12] And how have markets evolved to address these challenges in whole And in part.

BL: [00:08:17] It's a really good question because it's impossible to resolve them 100%. The strategy that's emerged as a market leader is the evergreen fund, and they take the form of a tender [00:08:30] fund such as the ones we offer and its closing the interval fund, these evergreen funds tender interval or continuously offered, and they continuously invest in many ways. A good analogy would be a mutual fund. So in a tender fund, capital inflows is subscribed for on a monthly basis. Those funds like ours typically offer quarterly liquidity, so monthly inflow, quarterly outflow and they're designed to deliver the illiquidity [00:09:00] premium. You talked about earlier, Michael, of private market assets in a format with quarterly liquidity. They typically provide a 1099 The minimums are quite reasonable. Ours are $50,000. That's generally what you see in the market. And so they're they're available to the affluent investor, not just the ultra high net worth investor. Also like a mutual fund, a tender fund typically offers a drip option, a dividend reinvestment option, which is very convenient when I personally do.

And frankly, the most [00:09:30] of our investors in in our products do to stay invested and just keep your capital compounding. They can be held in a tax deferred account. You can hold a drawdown fund in a in an IRA. I personally do it. It's extremely complicated, time consuming, and you do it in the part of your portfolio that generally has the longest term investment horizon, your retirement money. So it's super convenient and then it's transparent. So in typical drawdown fund, you get a capital account statement [00:10:00] 60 to 90 days after quarter end in an evergreen fund, you don't get a daily vow, but you do get a monthly statement around the middle of the following month. So sort of a 15 day lag. And so on balance, we think this is a much simpler solution for individual investors who want to. Know what they own and want to be able to maintain a consistent asset allocation.

MV: [00:10:21] I wanted to talk a little bit more about tender funds, but let's put a pin in that for the time being. Let's discuss the products. [00:10:30] We currently have two that are geared toward individual investors—SPRIM and SPRING. Could you briefly talk about them and explain how they overcome these barriers to access?

BL: [00:10:41] Love to talk about our products. SPRIM is our core holding. It's the simple one stop solution for individual investors and small institutions. It invests across all the private market asset classes, private equity, real assets and private debt. And it accesses those [00:11:00] primarily by buying funds on the secondary market we call secondaries and co-investments in direct companies and individual companies, alongside leading private market managers with a very modest amount of primary commitments to new funds. It does this on a global basis, and it's available to accredited investors, investors who have $1,000,000 of investable assets with a $50,000 minimum. It provides a 1099, as we talked about, and this fund offers quarterly liquidity of 5% of [00:11:30] the net asset value of the fund. And this is an important distinction. Often confused the 5% applies at the fund level, not at the individual investor level. So our expectation is that most investors, when they want their liquidity, can receive liquidity, can get their money back in most quarters in full. And importantly, when we do provide that quarterly liquidity, it's at 100% of net asset value, not at the discounts you would see for sales of secondaries in the broader [00:12:00] institutional markets at 5%, liquidity quarterly, 100% of net asset value on about 60 days' notice, we charge a 1.4% management fee in SPRIM. There's no incentive fee. We believe we're the low fee provider and our market in that space started this fund two years ago. It's off to a really strong start. It already has a highly diversified portfolio spanning mostly private equity, but also including real assets and private debt.

BL: [00:12:25] It covers over ten vintage years, so it's quite diverse in terms of when the companies were invested [00:12:30] in. And our investments are alongside 100 different fund managers. And of course, past is not always prologue. Past results don't guarantee future results, but we're very, very happy with the results, investment results and the diversification and the uptake, the adoption of SPRIM here in the first two years. Love to talk now about our new fund, SPRING. SPRING is focused on venture capital and growth equity. We're investing in all aspects of the innovation [00:13:00] economy as the term we like to use, the most dynamic technology sectors and companies that benefit from secular trends that we deem very attractive, such as digital integration, the adoption of technology and a broadening set of industries, cloud computing, just to name a few. So venture capital, of course, can span a wide range of risk and return profiles, from the very earliest seed stage where the risk is extremely high. And of course the return can be extremely high to very late-stage companies that are about to go public [00:13:30] for SPRING. On balance, we believe the ideal company, what we're targeting is companies that have proven their ideal works, and that there's a market for their idea. And now their challenge is to execute on a long-term steep growth plan. So for the individual investor in this permanent capital structure, we think those companies, if you're technical, you might think of them as Series C or Series D round companies in general.

BL: [00:13:59] It's [00:14:00] that stage that's the sweet spot for SPRING. SPRING is a global fund investing its capital primarily in North America, but also other economies where there's innovation and high growth. The companies and the assets that will go in SPRING or mostly secondaries, mostly funds purchased on the secondary market, but also a very meaningful portion of individual companies purchased on the secondary market where we are buying from prior investors. Former employees. SPRING is an evergreen [00:14:30] fund like SPRIM, but in SPRING, because of the nature of the assets, we offer two and a half percent liquidity quarterly, not 5%. SPRNIG is available to qualified clients, investors who have $2.1 million of investable assets or more. It does have the same $50,000 minimum. In terms of fees, we charge a 1.5% management fee and a 15% incentive for a fee package we believe is very attractive in comparison to our peers. So [00:15:00] SPRING is a new fund and we don't yet have a meaningful track record. That said, we do believe it's a very interesting time to be investing in venture capital. This is a market that's been repriced; asset values have come down; and venture investors are bringing a discipline to the market, focusing on companies that have a clear path toward profitability and a reasonable period of time. So we think our timing is opportune with respect to bringing SPRING to the market.

MV: [00:15:28] Now that we've talked about ourour products. I'd like to talk a little bit more about tender funds as a structure. It sounds like they've caught on, but could you talk about some of the cons associated with tender funds?

BL: [00:15:43] Yeah, happy to give you a balanced view of that. Tender funds are a hybrid. They sit between the daily traded exposure, the publicly traded stocks and bonds and 15-year lockup traditional drawdown fund. The tender fund does require 60 days or so. We're 60 days, our peers are older [00:16:00] about that. In our tender funds, we offer liquidity on 60 days' notice. So there is a notice period. It's not immediate. And secondly, the liquidity is not absolutely guaranteed. It is in the discretion of an independent board, not us as the manager, but an independent board, and they hold that discretion to make sure in times of extraordinary stress, dislocation, etc. So we run scenarios like the global financial crisis, but longer [00:16:30] to make sure we can provide that liquidity. But again, it's not guaranteed. In terms of adoption. We've been very pleased since our strategy has crossed $1,000,000,000, we've seen increased interest from ultra-high net worth individuals and family offices and true institutional investors. Institutional investors, of course, their portfolios, their private portfolios are dominated by traditional drawdown funds. Institutional investors recognize that with an evergreen fund, they are committed but not necessarily [00:17:00] invested. To be really blunt, in a drawdown fund, the general partner, the sponsor of that fund is outsourcing cash management, liquidity management, to the investor. In an Evergreen fund, we as the manager accept that responsibility to get you the investor and allocation to the assets and our fund, not just a commitment.

BL: [00:17:23] And so institutional investors and ultra-high net worth or embracing the evergreen fund and their use cases break down [00:17:30] into three categories. First, in some cases they are preferring it as their single solution, their single investment. They don't like doing capital calls and distributions and having a K-1. So they they adopt an evergreen fund strategy, only investing in evergreen funds. Larger institutions tend to use the evergreen fund as a complementary strategy. So perhaps their target is 20% private markets. They've got commitments to a series of private of traditional drawdown funds that have caused distributions, [00:18:00] cause distributions unpredictably—hard to ever get to that 20% target allocation. But if you take 5% and put it in Evergreen Fund, well, you know, you've got that 5%. So they use it to complement their drawdown funds. And finally, very sophisticated institutions are using evergreen funds as a portfolio optimization tool. So they commit to those drawdown funds, they know that capital will be drawn over time. They're able to model that [00:18:30] they want to get to their target allocation. So they put money in the ground today to with an evergreen fund with the expectation that they reduce that over time. Do they get to their ideal balance between an evergreen fund and the traditional drawdown? What gets me excited is to give sophisticated fiduciaries another portfolio management tool to hit their goals. And that's what we've done with the evergreen fund.

MV: [00:18:56] I'm really glad you brought up liquidity and realizations. [00:19:00] You know, as you know, one of the things that differentiates private companies from public ones is this idea of patient capital, right? Whereas public companies may be pressed to meet short term earnings goals private market firms can control when they exit a deal or sell an asset. If valuations are where they want them, the general partner can wait a little longer in order to meet their target return. For a long term closed end fund structure, that works right? You get 4 to 5 years, maybe longer, [00:19:30] to bring a plan to fruition. But sounds like with a tender fund which offers greater liquidity, you need more frequent realization activity. How to tender funds like SPRIM and SPRING deal with this tension.

BL: [00:19:43] Michael, that's a really important question. And I think one of the hardest things about running a tender fund. Tender funds are designed to start and stay on the upswing of the J curve, which is sort of a trite phase. But what that what that means is we need to provide the liquidity and we do that by investing, [00:20:00] creating a mature self-funding portfolio that's constantly creating realizations. And to do that, we need to buy mature secondaries, secondaries that are close to their realization phase and just constantly manage the portfolio. So it's all in that upswing of the J curve. In addition, in SPRIM, we include a modest allocation to real assets and private debt, which have a natural cash flow component.

MV: [00:20:27] So, Bob, I want to talk about the current market [00:20:30] conditions, if you'll indulge me. Owing to these apparent headwinds, lower valuations, more difficult exit environment and rising rates, an individual or their F.A. might say, “Let's wait to see how things shake out before changing our portfolio too much.” What would you tell them?

BL: [00:20:48] First and foremost, you simply cannot town the private markets. Lots of research, including our own, has consistently supported the wisdom of investing in the private markets across cycles, getting [00:21:00] vintage diversification. Moreover, historically, periods of volatility and uncertainty in the public markets have produced some of the best private market returns.

MV: [00:21:10] We've covered a lot of ground. Bob, is there anything else that you'd like to say?

BL: [00:21:15] I think one point I didn't sufficiently emphasize, an evergreen fund is an opportunity for individual investors to dollar cost average in the private market. And Evergreen Fund provides that opportunity. And we think that's critically important for investors [00:21:30] to keep in mind as they seek to optimize their portfolio and get the exposure to the private markets.

MV: [00:21:37] Bob, it has been a pleasure as always.

BL: Thank you.

MV: Thank you for listening to this episode of RPM to learn more about StepStone Private Wealth. Head to stepstonepw.com. RPM is available on Apple Podcasts, Spotify, Stitcher and other podcast platforms.