Private Equity: Process & Structure for Outperformance

INTRODUCTION

Windrose Advisors is celebrating its 10th Anniversary in 2019! From day one we've embraced the private equity asset class for return potential, portfolio diversification and tax efficiency reasons. From investments in early-stage venture capital, growth equity, buyout and special situations strategies, we recognize the value of each strategy to successfully generate a premium to the performance of public markets as well as increase portfolio diversification. We firmly believe that private markets are less efficient than public markets and skilled managers can generate significant alpha through disciplined and focused approaches to investing.

Since our first private equity commitments back in 2011, Windrose Advisors has committed over $300 million across private equity strategies. Roughly 60% of those committed dollars has been to buyout and special situations strategies, while the remaining 40% to venture capital and growth equity strategies. Our core portfolio now consists of 15 managers who consistently generate alpha and are diversified across strategies, geographies, sectors, and company life-cycle. Our portfolio includes established and emerging managers, leveraging our due diligence capabilities and manager access to often over-subscribed funds. Importantly, this portfolio of 15 core managers provides sufficient diversification to help reduce downside risk but is not so overly diversified that it inhibits investors from beating the benchmark.

In what seems like an eternity ago, our private equity program took an important leap forward by structuring fund commitments into vintage year commingled structures (or private equity sleeves) for clients. This improvement offered many benefits to clients, such as providing diversified private equity exposure at low minimum amounts as well as reduced administrative complexities. In addition, the investment team has realized efficiencies in process and execution while removing unnecessary friction in the investment process. We believe the asset class will continue to outperform public markets over the long-term and offer important diversification and tax benefits to clients.

As our private equity program matures and evolves, and our early private equity sleeves reach a point at which performance can be benchmarked against peers, we can take stock in our accomplishments: what has worked well and how we can drive sustained outperformance in the future.

PERFORMANCE REVIEW

Our first private equity sleeve vehicle was launched in 2016 (WA PE V) and we have deployed a vintage year sleeve every year since that initial launch. As 2019 comes to a close, Windrose has deployed four private equity sleeves (WA PE V, VI, VII & VIII) that each contain 4-6 private equity fund commitments. While the underlying investments in these sleeves are still very young, our sleeves, in aggregate, have generated a 17.1% net IRR, whereas the public market (MSCI All Country World Index, or ACWI) has returned 8.0% annually over the same time period.[1]

Table 1 summarizes key performance statistics for WA PE V & VI.[2] Typically, private equity investments are classified and benchmarked by vintage year against a peer group of comparable funds investing over a similar timeframe and consequently, in a similar investment environment. As these funds take years to be deployed in portfolio

[1] January 2016 – June 2019 and gross of WA advisory fees

[2] As of 6/30/19

Private Equity Sleeve Program Performance Benchmarking	WA PE V 2016	WA PE VI 2017
Vintage Year	2016	2017
Net IRR	22.7%	13.7%
Net MOIC	1.33x	1.11x
Net IRR Quartile	**1st**	**1st**
Net MOIC Quartile	**1st**	**1st**
Paid-in Capital (%)	61%	39%
Percentage of 1st & 2nd Quartile Funds (Net IRR)[5]	70%	91%
Percentage of 1st & 2nd Quartile Funds (Net MOIC)[5]	70%	91%

WA performance data as of 6/30/19 & gross of WA advisory fees

companies, currently benchmark data is available only through 2017 vintage year investments.[3]

As such, WA PE V and VI are our only private equity sleeves that can be benchmarked thus far. Both sleeves have delivered what is considered to be top quartile returns based on net internal rate of return (IRR) and net multiple of invested capital (MOIC) against a group of peer funds from the same respective vintage years.[4] While the underlying funds are still young and continuing to make new investments into portfolio companies (based on percentage of paid-in capital), they have already increased in value as strategies are implemented to increase revenue growth and profitability at the portfolio company level.

At the manager level, most of our committed capital in each private equity sleeve is with managers that are currently tracking in the first or second quartile based on peer performance.[5] For the managers ranked in the second quartile (on both an IRR and MOIC basis), these managers are tracking very closely to the first quartile cutoff points. Based on their historical track records, strategy and our underwriting, we remain confident that they should move into the first quartile as well, as their portfolios mature.

SUSTAINING OUR TRACK RECORD

The early performance of our private equity sleeves conforms to the commonly held belief of institutional investors that private equity is an important part of a diversified portfolio and can offer outperformance compared with public markets for those investors with a long-term investment horizon. While this may be true, realizing those returns is easier said than done. For us, we are not surprised. We have achieved strong private equity returns in the past and have a client base, firm structure, and portfolio approach that has allowed us to build a platform of top-performing managers that are

[3] Based on Cambridge Associates Global Private Equity benchmark

[4] WA returns as of 6/30/19 quartiled against Cambridge Associates Q1 2019 Global Private Equity benchmark data

[5] Commitments on a dollar weighted basis as of 6/30/19

aligned with our long-term goal of sustained outperformance.

EMBRACING THE ILLIQUIDITY PREMIUM

As an independent advisor focused on families, endowments and foundations with significant assets, we work with investors who understand the benefits of patient investing and have the ability to accept a level of illiquidity, referred to as the "illiquidity premium" in private equity , in exchange for creating long-term value. By focusing on long-term returns, we can invest through periods of volatility and take advantage of market dislocations to effectively extract an illiquidity premium. Furthermore, the strategies that many of our private equity fund managers deploy are focused on building and growing companies, which can take time as capital investments are made in talent, technology, products and strategy at the portfolio company level that ultimately become realized to investors through fund returns.

QUALITY OPPORTUNITIES

At close to $3.0 billion in assets under advisement, we are large enough to be desirable capital partners to private equity managers. Yet our size is also small enough to afford the ability to participate in a broader universe of smaller investment opportunities that can have an outsized impact on portfolios. This is especially relevant for emerging managers and many venture capital funds, as fund sizes are typically smaller relative to the broader private equity ecosystem. The highest potential managers in these segments have limited allocations for investors, and far too often outsized demand. As a result, many large pools of capital have difficulty underwriting these capacity constrained opportunities as they have mandates to commit large amounts of capital every year and those limitations make it inefficient based on a time to dollar ratio. Windrose, on the other hand, can be a meaningful partner to managers raising smaller pools of capital. That said, part of our formula for sustained outperformance is gaining access to top performing managers whose funds are typically smaller and usually oversubscribed.

ACCESS TO EMERGING MANAGERS

As noted, our private equity sleeves include fund commitments with both established and emerging private equity managers. Within the emerging category, Windrose has made commitments to six emerging managers (seven funds) across our private equity platform, which we define as a Fund I, II or III. To date, these investments have, in aggregate, generated a 22% net IRR[6]. This strong performance is consistent with our underwriting and belief that select emerging managers can outperform more established managers, and often provide innovative strategies not previously or adequately addressed by existing managers, thereby providing the potential for greater alpha generation. Investments in emerging managers can also be a method to ensure our desired allocations with access to managers that limit capacity further as they become more established and recognized.

EXPERIENCE AND SOURCING NETWORKS

Complementing our client and firm characteristics, sourcing is a differentiating factor. We have built a well-resourced investment group with experience across asset classes and market cycles as well as deep networks with allocators and managers alike. This is important as private equity remains very relationship-based. Consequently, it has become exceedingly important to create strong ties with top-performing managers, especially as institutional investors continue to increase private equity exposure, targeting capacity constrained strategies. To ensure that our platform is comprised of the highest quality managers, we have strived to remove friction to good-decision making and enable team members to express their best investment ideas developed over decades in the business through our sleeve program.

PORTFOLIO CONSTRUCTION

Since the formation of our private investment program we have selectively invested across private equity strategies. Our approach is not focused on filling top-down strategy 'buckets' or diversification at the expense of mediocre investments. Rather, we

[6] As of 6/30/19 & gross of WA advisory fees

opportunistically invest with the best managers who consistently produce top-quartile returns and can demonstrate that a repeatable process is in place for continued alpha generation and alignment of interest with investors.

As we've written about previously in the "Magic of 15", our strategy is to build a portfolio comprised of roughly 15 core managers who consistently create outsized alpha and with whom we can re-invest over time. We have found that this approach to portfolio construction provides enough diversification to help reduce down-side risk yet is not so overly diversified that it inhibits investors from beating the benchmark.

Furthermore, our approach to portfolio construction and manager selection means that on any given year, our vintage year private equity sleeve may be more heavily weighted to venture or buyout strategies, depending on which managers are raising new funds. This is OK, as each private equity sleeve is not designed to be a fully diversified program. Rather, a deliberate, steady approach of commitments over multiple years through the sleeve program is intended to result in diversification at the vintage year, strategy, geography, sector and life-cycle level.

CONCLUSION

For long-term investors seeking to build a diversified and alpha-generating portfolio, we believe private equity is a key component. The long-term outlook for the asset class is strong. The private equity model, when well executed, has shown that it can outperform public equity markets in a wide variety of economic and capital market conditions. The qualifier is important. The ability to identify, access and select top quartile funds is what will separate an average private equity portfolio from one that outperforms the public markets by a wide margin.

Through a well-established process and structure for manager selection, portfolio construction and sourcing, Windrose is well positioned to continue investing with high-performing private equity managers and to deliver strong risk-adjusted returns. Windrose's first decade has shown that to be the case. We are excited to see our private equity sleeves mature and produce superior performance in the years ahead.

DISCLOSURES