Verus

# Memorandum

**To:** Board of Trustees, Fresno County Employees' Retirement Association

**From:** Mike Kamell, CFA, CAIA, Consultant

**Date:** March 2, 2016

**RE:** Annual Private Assets Update

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This memo serves to provide an informational update regarding FCERA's private equity and private credit investments. As of December 31, 2015, the estimated market value of FCERA's private equity investments was approximately 2.5% of Plan assets, compared to a 6% target. Similarly, private credit strategies represented 1.8% compared to an 8% target. While still well below the current target weights, FCERA has made measurable progress towards prudent capital deployment, particularly in the last 12 months.

**Overview of Private Assets Program**

The primary rationale for the program is to earn a premium relative to public markets investing for bearing illiquidity. The challenge associated with this is with illiquidity FCERA foregoes the ability to liquidate a poor performing investment, as they can in public markets. For this reason investing in private closed-end partnerships requires significant amounts of up-front due diligence, from both a top-down and bottom-up perspective. Another challenge brought about by illiquidity is getting capital invested takes time, as even once a fund is properly vetted and approved, FCERA is still beholden to the general partners to call capital to fund investments that are consistent with the goals and constraints of the fund. It is not uncommon for the underlying funds to call less capital than is committed should their investment pipelines not provide ample opportunities to deliver on their return objectives.

As of December 31, 2015, existing commitments totaled $490 million, with a current market value of $165 million. For comparison purposes, applying the 14% target weight to the current total portfolio market value generates a target value for private assets of $540 million. In aggregate, 90% of total commitments have already been called, suggesting the underlying assets are very much in the "harvest" phase of the private assets lifecycle. The implications for this are that future commitments will need to be made at an escalating pace, not just for purposes of reaching target but also in order to preserve the current exposure.

**Recent Activity: Private Equity**

Private equity as an asset class was heavily impacted by the great financial crisis. Private deal flow essentially came to a halt for a prolonged period. FCERA made commitments to three funds with 2007 vintage years, and as a result of the market dynamics that followed, they took longer than anticipated to be able to deploy capital. As a result of this “dry powder” FCERA did not make any private equity commitments for several years following the crisis.

In July of 2015 Verus presented a private equity search to FCERA, this process culminated in FCERA investing in two private equity funds. The first, Hamilton Lane Fund IX, is a private equity fund of fund. In this regard, the fund provides exposure to 25-35 underlying private equity funds (much the same as a hedge fund-of-funds is structured). FCERA’s $70 million commitment should materially improve the sizing of the program relative to target, however the nature of the fund-of-funds structure means that it will take longer for the commitments to be called down relative to a traditional direct investment. During the July meeting Verus also introduced a recommendation to commit to Warburg Pincus XII, a large multi-strategy private equity fund. The legal due diligence for this investment was expedited, and the investment was finalized in November of 2015.

**Recent Activity: Private Credit**

FCERA designated an 8% target to private credit as a result of the 2013 asset-liability study. Prior to this these types of strategies did not have an explicit target, rather private equity and credit were grouped together as one asset class. Notwithstanding the lack of an explicit target, FCERA had commitments to private credit strategies spanning back to 1998. During 2015, FCERA committed a combined $60 million to two private credit funds (GSO European Senior Debt and CVI Credit Value). As of December 31, GSO had called 5% of the $30 million commitment while CarVal called 25%. At the February 2016 meeting, FCERA approved an additional $30 million private credit commitment, which is currently pending legal review.

**Performance**

At a high level, the performance of the program has been strong; since inception of the private assets program in 1998 the Fund has generated approximately a 1.5x multiple on invested capital, across all investments, on average. When looking at the distributions received relative to capital paid in, that metric currently stands at 110%, which is to say that in aggregate, FCERA’s private equity managers have returned 10% more capital than they have taken, and the current net asset value of 4.3% of the portfolio is “all profit.” The more common measure of private fund performance is the internal rate of return (“IRR”). At the Plan level, we can estimate the aggregate IRR by calculating the commitment-weighted average of each fund’s IRR. The average net IRR for FCERA’s private equity commitments was 12.4%, while private credit strategies have generated an average IRR of 10.5%. On a combined basis the program has generated a net IRR of approximately 11.5%.

**Next Steps**

As part of our annual Work Plan, Verus has proposed several tentative dates for which we anticipate bringing additional recommendations forward. Because of the number of factors that are hard to determine in advance (where we are seeing the best opportunities, and our ability to source new funds with capacity that align with those opportunities), this tends to be a fluid process. At this juncture we have tentatively identified several potentially attractive private credit strategies that we plan to bring forward in the second quarter. Furthermore, we intend to propose additional private equity strategies in the third quarter, the nature of these will depend on what opportunities are identified as part of our private equity outlook (slated for August discussion). As we bring forward additional strategies for consideration we plan to provide updated analysis regarding commitment pacing.

Please feel free to reach out to me with any questions.