Evergreen Funds: the Next Frontier for Private Markets Investors?

Investors looking to access private markets should consider the emergence of new structures, with open-ended funds providing a viable alternative – or complement – to traditional closed-end funds.

Since the dawn of investor interest in private equity, the humble commingled, closed-end fund has largely served investors well as a means to access private markets investments.

Limited partners have become accustomed to the process of selecting an adequate manager and fund, standing by for capital calls, and then patiently waiting for their returns to be harvested. But as private markets have evolved, different structures have emerged that can provide investors with new ways to access these markets. These new structures can help address key challenges faced by some investors.

The first is obvious from the outset: How do I get (fully) invested? While most investors will have a target allocation they want to achieve, many find they are never fully invested due to the nature of closed-end funds.

Even if an investor manages to achieve their target allocation, the next challenge is: How do I stay invested and compound my returns? An investor who starts to receive distributions from a manager must yet again find a new home for that capital and can experience reinvestment risk in the process.

Finally, many traditional funds will typically have a specific focus, such as a particular asset class, region or industry. Investors need to find the best relative value irrespective of asset class.

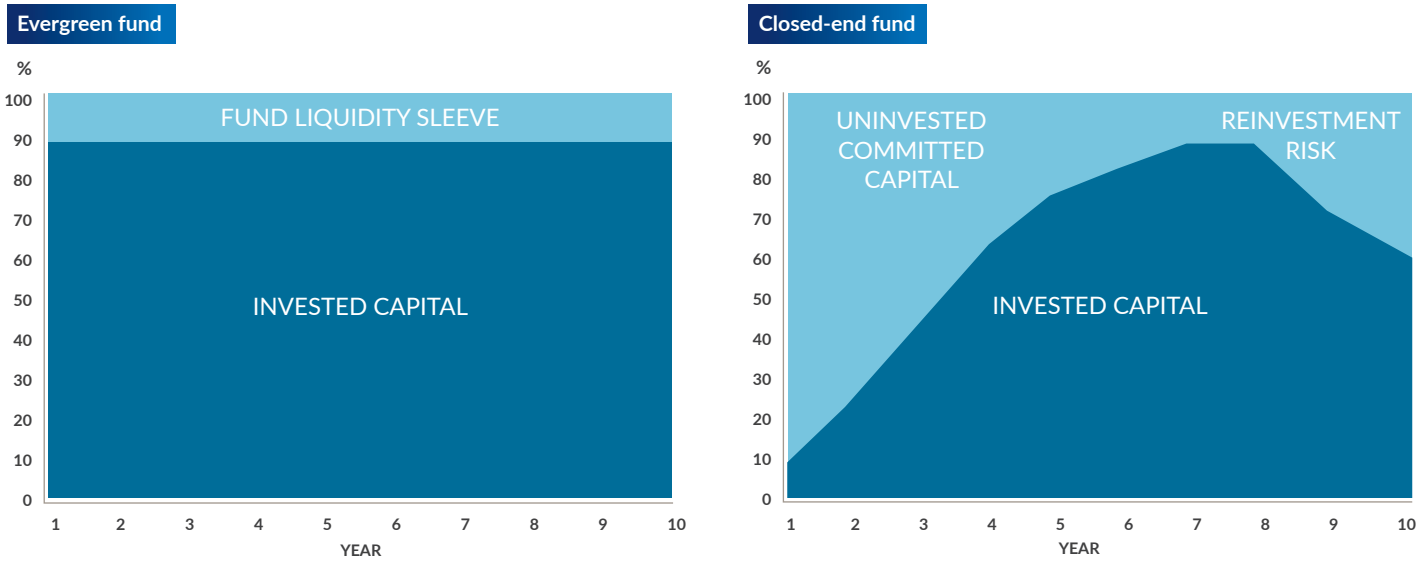
In this piece, we will illustrate how open-ended or evergreen structures can help meet these common investor issues.

Evergreen structures are not a complete panacea to the issues, however. After all, the success of open-ended funds is ultimately reliant on the investment acumen and investment flow of a manager. But we do expect them to become more commonplace as their advantages gain greater recognition.

Low visibility

The traditional model of allocating is based on a 'commitment' or pledge to fund a stated amount of capital to a manager, generally over the investment period. This is typically the first four or five years of the fund. Limited partners have relatively low visibility into the timing of capital call notices and must therefore keep reserves in very liquid, low-returning strategies. Once the capital commitment is called down, the very first investments in a fund are now likely ready to be harvested by the manager. This reduces the investment again and puts reinvestment risk back on the asset owner. ›

It is hard for your money to grow if it is sitting out of the show



Note: Closed-end fund refers to a traditional commingled blind pool private equity fund.
Source: Partners Group, February 2021. For illustrative purposes only.

An evergreen strategy's return is equivalent to a higher closed-end fund return

	Evergreen strategy average annual returns				
	9%	10%	11%	12%	13%
Closed-end fund IRR equivalent (uncalled capital in cash)	18%	19%	20%	22%	23%
Investment multiple	2.2x	2.4x	2.7x	2.9x	3.2x

Note: For a given evergreen strategy's return (top row), the required equivalent return on a traditional closed-end fund to reach the same dollar-on-dollar multiple (bottom row) is shown in the middle row. Closed-end fund refers to a traditional commingled blind pool private equity fund.

Source: Partners Group, as of September 30, 2020. All returns shown are net of fees and expenses. Closed-end fund capital calls and distributions based on real historical cash flow patterns from Cambridge Associates and adjusted based on Partners Group's forward-looking expected returns framework.

› In fact, it is not uncommon for just 60-70% of a limited partner's total commitment to be invested over the life of the fund. To be fully invested, one could be required to pursue an over-commitment strategy in the 130%-150% range.

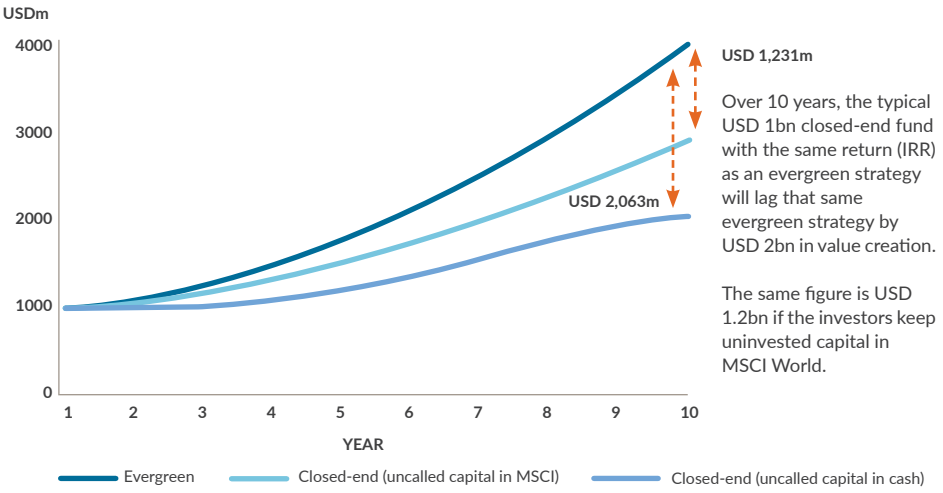
In contrast, open-ended vehicles allow investors to control their own investment level as each subscription goes into a fully funded portfolio.

Additionally, open-ended funds generally do not have a fixed term and will continue in perpetuity, hence their 'evergreen' reputation. The offering is typically always 'available' for new subscriptions. This gives investors more flexibility in portfolio construction. They can leverage their existing due diligence when they want to make another commitment, or they can control the pacing of their contributions.

We have seen that high-quality managers and well-performing open-ended funds may have a queue to subscribe as the manager is diligent in managing growth (and not diluting existing investors). This can also be the case if the manager is disciplined in waiting for a more favorable investment environment, or a compelling opportunity that meets the investment objective.

We should point out that open-ended funds generally price the underlying investments on a monthly basis. It is essential that the valuations of the underlying investments are fair and accurate as this is how the units are priced for buyers (new investors), sellers and existing investors. For many investors, the mark-to-market valuations will provide a more accurate and timely representation of the fair value of their investments.

It all adds up to a big difference over the life of the typical private equity closed-end fund



Note: Closed-end fund refers to a traditional commingled blind pool private equity fund.

Source: Partners Group, as of September 30, 2020. All returns shown are net of fees and expenses. Closed-end fund capital calls and distributions based on real historical cash flow patterns from Cambridge Associates and adjusted based on Partners Group's forward-looking expected returns framework. Cash is assumed to return 0.4% per year which is the 5yr Treasury yield as of December 31, 2020. MSCI World return used is 8%, which is the average annualized return from the inception of the representative account on 06/30/2009 to 09/30/2020.

Staying invested and compounding returns

Once investors achieve their desired investment levels (say 10-20% of their total portfolio), they must also pay attention to maintaining it. Often, as investors start to reach their target allocations, they will start to receive distributions from the fund manager or portfolio. When this happens, the hard work starts all over again. Not only does the level of compounding fall, but the investor must then assume the reinvestment risk and find a new suitable investment. Even short periods of underinvestment result in significantly lower performance than a perpetually invested fund.

Moreover, as overall portfolio values have grown over time, maintaining a target allocation to private markets requires frequent upward adjustments to an investor's absolute investment amount. Again, this can introduce potentially undesired timing risk for the investor.

Finding relative value

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› Often, investors will identify a theme or idea they want to pursue. Unfortunately, acting on this can take time as the investor will need to browse the marketplace to find the right manager and then wait for the next suitable fund to be in the market.

It might be a year or more before a single dollar is invested and the opportunity may have passed by then.

We believe that investors can benefit from a more flexible approach. In an open-ended fund, managers have broad discretion to survey the entire landscape and look for the best pockets to invest in at a given time. This might span across multiple industries, multiple strategies (e.g., direct versus secondary investment), and even multiple asset classes. By dynamically shifting allocations to the most attractive areas at the opportune times when risk/reward is compelling, we think investors can add significant performance to their portfolios.

We believe well-designed, open-ended evergreen funds or mandate solutions with an experienced and capable manager should be a viable alternative – or complement – to traditional closed-end funds. The ability to invest with flexibility, and nimbleness, is an important factor. Therefore, investors should look for managers that can invest directly into transactions and that have the ability to invest in a wide breadth of opportunities. Not only does this reduce the amount of double fee layers, but also allows for more precise and dynamic investment level steering.

Open-ended evergreen funds should be a tool in every investor's toolkit to help them overcome the structural and cyclical challenges of private markets. ■

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