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RPM Ep 10 Transcript

**MV:** You're listening to RPM, the podcast that explores the world of private markets. I'm your host Michael Venne. When we think of industries, like private markets, that measure their assets in the trillions of dollars, it can be hard to fathom they haven't always been around. Private markets are fairly young—private equity, for instance, only emerged in the late 1970s, making it about as old as the personal computer, and like the PC, private markets have become essential to the economy.

Today, most institutional investors have some allocation to private equity, infrastructure, private debt or private real estate, and solutions for individual investors have started to emerge. Here with me to discuss the history of private markets is Jason Ment, StepStone's President and Co-Chief Operating Officer.

**MV:** Jason, welcome to RPM.

**JM:** Thank you, Michael. I love the podcast. You guys have been doing a great job, and I'm really excited to be speaking with you today.

**MV:** I really appreciate that. So, Jason, you've worked in private markets for nearly 20 years, and today that isn't so hard to grasp since it is one of the hottest job markets globally, how did you wind up working in private markets?

**JM:** So maybe not hard for you to grasp, but I really can't believe that it's been nearly 20 years since my first venture capital deal. I have to say, that time has certainly blown by. I started my career as an M&A lawyer and I worked in a number of venture capital deals as a summer intern during law school, and then some more during my first-year practice. And I was really hooked, I love the dynamic and the energy around all of it. So as private market sponsors became a larger portion of my client base, private equity sponsors and VC sponsors, a move in-house as an attorney first to Citigroup and then to StepStone in 2010 was pretty natural, and the evolution of my career at Stepstone to more of a management and operations focused job, over time has felt more evolution than revolution as well.

**MV:** And what are some of the biggest developments in private markets that you've observed during that time?

**JM:** So, when I started, Michael, private markets wasn't even really a widely used term. People really spoke about private equity, maybe venture or, to some extent, real estate funds. But since then, we've seen a very dynamic environment. Infrastructure has become a completely investable private markets asset class, with sponsors around the world and different risk categories. Funds focused on direct lending rushed in, really, to fill the vacuum after the global financial crisis led to a real retreat by the banks in lending markets. Companies stay private for much longer now, and that's led to real scale opportunities to invest in the venture and growth areas in the innovation economy around the world. And really, I'd say there's a proliferation of choice. The number of active managers over the course of my career has more than doubled, and more than half that growth has come from outside the US, so it's a much more global market, and more than half the growth is coming from real estate, infrastructure, private debt and specialized strategies within private equity. So, the landscape is a lot more complicated for investors to navigate, but that rich tapestry of opportunities is what's really allowed for it to grow as well.

**MV:** That's really interesting. These sound like almost like responses to changes at the macro level: would you quickly go through some of the, I guess, macroeconomic developments that have kind of spurred on this growth and development?

**JM:** Yeah, there are a number of secular trends that are in play here. But to note a few of the more meaningful ones to take, first and foremost the persistent outperformance on a risk-adjusted basis of the private markets relative to their public market corollary is really a siren song for asset owners. And so that's led to a real inflow into the asset classes. The second that I would note is the influence of the low-rate environment, and the resulting need to find returns wherever you may, that really can't be understated, it's a major force, particularly for liability driven investors. Third, the globality of capital, right, where investors and asset owners sit has been a major force in the growth. While institutions in the US may have been the earlier movers in size, whether it be public pensions, endowments and foundations, large asset owners outside the US with lower exposure to private markets have been a tremendous growth engine over the last 15 years. The final one that I would note is there's a positive reinforcement loop. As capital moved into the private markets, sponsors have matured and proliferated, making the private markets more attractive to a wider group of investors, given that richness of choice.

**MV:** And do you believe the growth and maturation of the industry has changed the way that general partners do things?

**JM:** Without a doubt. In its earliest form, private equity was capital structure optimization. Twenty years ago, a very few numbers of private equity sponsors would tout their focus on operational improvements at the portfolio company level as a point of differentiation relative to peers. Now having an army of operating partners with specialized skill sets ready to descend upon each portfolio company to optimize performance, that’s table stakes. So that's a material difference in the value proposition. The second thing I notice, whether driven by regulatory oversight or the growing sophistication of the LP community itself, sponsors have by and large evolved from deal makers to asset managers. And a few examples of what I'm talking about there would be, first, more sophisticated portfolio construction and active management through position sizing, syndication of co-investment, use of capital call lines, or more recently, GP led secondary transactions. The second thing I note is that transparency has been a major theme, whether during due diligence, robust or even bespoke disclosure to investors after investment, and then finally publicly available information to regulatory filings.

**MV:** That's fascinating. So, with private markets becoming a larger proportion of institutional portfolios and GPs becoming more sophisticated and specialized, how have investors' expectations of their portfolios and of individual GPs changed?

**JM:** So, I'll take that in two parts. First, as an investor's allocation to private markets increases, the role of asset allocation, risk management, liquidity forecasting and the need for a more data driven approach toward investment selection and private markets portfolio management, has become required just as investors have in their public markets portfolio they need it for their private markets portfolio. An example there would be… you've seen ESG as a risk-lens applicable to all investments migrate from the public markets to the private markets. Asset owners really need a holistic view of their exposures to these types of risks across the entire portfolio when private markets comprise maybe 20% or even more of their assets. I'd also say that investors more actively manage their private markets portfolio today, just like they do in the public markets. Whether it be by trimming exposures through tapping the secondary market or leaning into certain sectors or geographies through co-investments. Second, as to the expectations around GPs themselves, as the allocations have increased, I think, you know, two things to note here. First, transparency initiatives kind of rhyming with what I said earlier, whether through individual investor initiatives, through side letter requests, which have just completely blossomed over the last 20 years, or collective action by organizations like the ILPA. Investors need the data from GPs in order to properly understand the portfolio. Second thing I note here is an expectation that GPs institutionalize their processes in order to mitigate risk. When we started looking at fund investments 20 years ago, LPs did not conduct any meaningful operational due diligence on GPs in the private markets, so a little bit in the hedge fund space. But now we don't make an investment here at Stepstone without having our dedicated operational due diligence team review a myriad of middle and back-office processes.

**MV:** So, it's really hard to imagine performing any investments without a robust operational due diligence process. I'd like to return back to something you mentioned earlier. I think secondaries exemplify this change in thinking. A couple of decades ago, LPs were concerned about the reputation and being able to invest in subsequent funds, if they asked to exit the fund early. Are we seeing this same change in mentality amongst GPs to viewing LPs as long-term partners in other asset classes?

**JM:** Yeah, I think that stigma is really a thing of yesteryear. The rise of the secondaries market, whether it be in private equity, real estate, infrastructure or even we're starting to see in private debt, has had a profound impact on the private markets, by giving LPs an ability to manage their portfolios and GPs have really embraced the secondary market as well, using it to recapitalize portfolios and provide some of their LPs with liquidity while offering those that want to stay in a specific investment or group of investments and ability to do so while the GP can maintain control of a cherry-picked portfolio company or group of companies. In fact, a little bit more than half the volume we saw in the first half of 2021, were actually single or multi-asset GP-led transactions. And that's in the context of a secondary market that is just so much larger than it used to be. If you look at the overall first half 2021 volume relative to just 10 years ago, the deal volumes quadrupled. That's a shocking growth, really. And this gives LPs a very powerful tool to be able to find liquidity when and where they need it in trimming their portfolio, but also an ability to deploy and ramp their portfolio or diversify their portfolio by going to the market to kind of find what they need. Finally, I guess I'd say, while buyouts were clearly the first area targeted by secondary buyers, growth equity and venture have made a real rise in terms of the allocation that you see from secondaries buyers and real estate infrastructure and private debt, well newer in terms of private markets asset classes, are all seeing increased secondaries activity and that's making those private markets more liquid. And in the long run, I do believe that a healthy secondaries market supports broader growth of the private markets as a whole.

**MV:** I'm glad you brought up the growth prospects of the industry. As we mentioned at the top of the show, most institutions have some allocation to private markets, and that allocation is often capped at a certain level. Are private markets reaching a point of saturation in the institutional market? And where are managers looking for the next growth opportunity?

**JM:** Yeah, you're certainly right that institutions typically set a target allocation for private markets and that may be broken down further with targets for private equity, private debt and real assets, or even more specifically for real estate infrastructure and other real assets such as agriculture or timber and the like. And some institutions are certainly closer than others to achieving their target allocations, but a couple of points here.

1. As the rest of the portfolio continues to grow, whether through investment gains or other inflows, depending on the investor type, that could be insurance premium or pension contributions or otherwise, this really drives a need to invest additional capital in the private markets in order to even stay flat, and much less meet targets.
2. I would note that institutions have increased targeted allocations to private markets routinely as the macro trends we discussed earlier have persisted for quite a while now.
3. Third, there's been robust realization activity in the private markets and there's therefore a need to reinvest that capital back into the private markets, even just to stay flat. So that leads to activity in its own right.
4. When looking at non-US institutions, they are typically actually quite far from their target allocations.
5. Institutions everywhere, whether in the US or otherwise, generally remain well under target in the newer private markets asset classes, whether it be infrastructure or private debt. They're still really building their allocation and it takes a while, particularly through primary fund commitments that drawdown over time.
6. I haven't yet touched on the last part of your question: additional areas for growth. There are additional pools of capital that are wildly under-allocated relative to institutions, and that can be things such as high net worth individuals or, more recently, mass affluent individuals that really have very low allocations relative to institutional counterparts, and they're accessing the market through unique structures at sometimes, in a way semi-liquid structures, even. Relatedly, while defined contribution plans in certain non-US markets are and have been active participants for a long time ( I'd give you the example of Australian superannuation plans as an example) DC plans in the US are largely unallocated at all to private markets, and at some point that's going to change in a big way, and we'll see the full democratization of private markets as people refer to it, when that does come to pass.

**MV:** And as private markets become, as you put it, more democratized, I think we should expect to see more scrutiny from regulators. What effect would greater regulation and oversight have on advisors and asset managers?

**JM:** You're certainly right. As the asset classes are accessed by individual investors, that's certainly going to draw more attention, whether it's from the executive branches, legislative branches, regulatory, etc. But I would say that the private markets firms have adapted very well, both in how they manage their firms and how they invest capital in what's been a changing and dynamic regulatory environment during the entirety of my career. Here in the US, when the Dodd-Frank Act was passed following the financial crisis, and GPs needed to register with the SEC or, with the analogue in Europe, the AIFMD, that was applicable to private markets firms, and most recently, of course, with Brexit. All of this has impacted the way GPs operate. But I personally would not expect that the resiliency and adaptability of the sponsor community to really be any different looking forward.

The private markets are also very global today, as I noted earlier. In where capital is raised and where capital is deployed and where professionals live and work. The private markets industry as a whole is very well positioned, I think, to capture the market and regulatory tailwinds wherever they may blow around the world. And we shouldn't forget that some LPs, not just GPs but LPs too, are subject to regulation that is relevant, whether Solvency II or Basel III or their successors or ERISA here in the US. And while regulation may make certain corners of the private markets more expensive or less accessible from a regulatory perspective, that it's going to require solutions-oriented approach on structuring or reporting requirements or the like. But I really have every faith that the GP community will rise to that challenge.

**MV:** Jason, it looks like we are out of time. Thanks again for taking the time to speak with us today, be well and hope to see you again soon.

**JM:** Michael, thank you for the opportunity to speak with you all, it's been a pleasure.

**MV:** That does it for this episode of RPM. Stay tuned for new episodes every few weeks. If you enjoyed this episode, please visit our show page at www.stepstonegroup.com. You can also find RPM on Apple, Spotify, Stitcher, and other platforms.

Before we go, I'd like to announce a new project that we have been working on. As some of you may know, October is when a couple of big climate-change initiatives take place. New York City climate week kicks off and so does COP26 in Glasgow. To raise awareness for these initiatives, RPM is releasing 3 special episodes in which Suzanne Tavill, StepStone's head of responsible investment, will interview responsible investment experts from organizations including the European Union, the World Wildlife Fund and others. I've just listened to the first episode and its really neat. Linda Romanovska, one of the architects of the EU's sustainability platform explains the ins and outs of the EU Taxonomy. If you're at all interested in ESG, RI or sustainable finance, please listen and share. Cheers.