For Private-Equity Success, Commit To Riding 'The J-Curve'

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Bob Long, chief executive officer at Conversus, which manages the Conversus StepStone Private Markets Fund. Read the Q & A below as Bob returns to the NAVigator to discuss private equity and how investors looking for success must commit to overcoming the J-curve, the start-up period when private-equity investments tend to lose money in the early days in order to be positioned for long-run success. Individual investors wanting to avoid the pain of those start-ups through diversification are increasingly turning to interval funds and business-development companies in the space, finding assets that are less correlated to the stock market, but which can ride out the volatility of the J-curve to benefit from start-up and private-equity exposure.

Bob Long

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Bob Long, chief executive officer at Conversus is here and we're talking about investing in private equity and riding the J-curve, this is The NAVigator. Welcome to The NAVigator, where we talk about all-weather investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active

Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry. From users and investors to fund sponsors and creators, if you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. And today it's pointing us in the direction of private equity and looking into some of the advantages that large institutional investors enjoy in that space. And we're doing that with Bob Long, president of Conversus which is part of StepStone. If you want to learn more about the company and what they do, Conversus.com. If you want to learn more generally about closed-end funds, interval funds, business-development companies, go to AICAlliance.org, the website for the Active Investment Company Alliance. Bob Long, thanks for joining me on The NAVigator.

BOB LONG: My pleasure, Chuck.

CHUCK JAFFE: Bob, private equity and the J-curve, it is something that, hey, as you're going for high-net worth investors and folks who might be interested in getting into private equity who haven't necessarily had a stake, it is like the first thing that they have to understand. And for some of them, they're hearing about the J-curve for the first time. So explain what it is that we're talking about, and why it is so essential that you ride it to get to success.

BOB LONG: A J-curve is the tendency in a private fund for an investor to experience negative returns in the beginning. With a typical private fund you commit to invest over time, often six or seven years, in an investment period for a fund that will last 10 or 12 years. So you have the unpredictable capital calls, when your capital's actually called from you and invested, and it comes back to you in an unpredictable fashion. Because those start-up expenses cost and because the investments generally don't produce positive returns in the first couple of years, returns go down, and then presumably if it's a good fund go up, creating the depiction of the J-curve.

CHUCK JAFFE: The J-curve, some people what you're really hoping for is what they call a hockey stick takeoff, that's the J-curve kind of in the form of a hockey stick basically. But since you've got this uncertainty with whatever you're investing in that's brand new, when you're piecing it together, how much do you want to make sure that you're diversifying your investments across various points on the J-curve?

BOB LONG: Very good question. It really comes down to this; most investors are trying to get to a disciplined, specified amount or allocation to that private asset. And when you

commit to a series of funds and the capital is called from you in an unpredictable fashion, it's really hard to get to your desired allocation, your desired percentage. And so having a variety of investments, calling capital at different times and returning capital at different times is one way to sort of stay where you want to be on the J-curve.

CHUCK JAFFE: You have made it very clear in discussing private equity in the past that people have to not just be like, "Oh, I want to have private equity." Because quite honestly at the beginning part of the J-curve it's going to beat you out of private equity. You have to overcome the J-curve. What is the difference that "I'm committed" versus "I'm in it. I'm riding it out"?

BOB LONG: So this is something that's really not well understood. So as I said before, you commit to a fund, imagine you commit a million dollars to a fund and it calls that capital from you. Typically on 10 business days' notice over a period of three to four years. Unfortunately you're typically paying fees on that capital even before it's invested. That's part of what gives you that negative experience, that down slope of the J-curve. The point is, with a typical private fund, the large sophisticated investors can handle the J-curve. What most investors want to do is get away from a J-curve.

CHUCK JAFFE: What it sounds like to me is a significant difference between the way institutions think and the way individuals, even high-net worth individuals think. The institutional investor, they know what they're getting into, they understand the J-curve, they're willing to buy in at the first point and ride it out. The individual kind of goes, why do I want to be here when you're in that money losing thing? Let me try to find something that's going to get me when I'm further up in the curve. Am I right about that? And if so, what are the benefits that that individual investor can get by, as you say, committing to the J-curve even at those earlier points?

BOB LONG: This is a really good point. So if you're a large institution, say like a Harvard Endowment, you're managing a whole series of J-curves for many dozens of investments, and you've got a staff keeping your capital perfectly invested pursuant to your desired asset allocation before it's called or when it comes back to you. Again, not only is it called unpredictably from you, it comes back unpredictably to you, giving you reinvestment risk. So really, and I don't think I've explained this well so far, the typical drawdown fund, the typical private equity fund, they're outsourcing cash management to you, the investor. So for

a large institution, that's manageable, they're expert in that. For the individual, that's generally very hard. Because what you've seen is individuals becoming more interested in permanent capital vehicles, BDCs, tender funds, interval funds and similar structures, because in those funds it's more like a mutual fund. They handle the cash management for the investor and commit to provide the returns, their targeted returns, from the beginning. Effectively overcoming the J-curve, or we like to say, start and stay on the upswing of the J-curve.

CHUCK JAFFE: The private investment market for most individuals is vexing, and yet these days with alternatives and trying to come up with other things and ways that you can overcome a market that has a lot of different things pulling it in different directions, structure matters. So help everybody understand when you'd rather go more towards private, when you'd rather go more towards those classic funds.

BOB LONG: So I think the distinction you're drawing is between a permanent capital vehicle and a typical drawdown fund. So the advantages of the typical drawdown fund is the internal rate of return or IRR may be higher. The advantages of the permanent capital vehicles are your capital gets invested from the beginning and stays invested. You have more liquidity, these vehicles typically offer quarterly liquidity. They're generally a 1099 and you avoid the dreaded K-1 partnership tax reporting. And they typically have lower minimums, often as low as $50,000, some cases $25,000. Whereas the typical private fund is going to be minimum $250,000 and often a million or more. Those are the structural differences. And while you've seen a substantial growth in the permanent capital vehicle market, BDCs, tender funds, and interval funds.

CHUCK JAFFE: For anybody who's looking at, how can I deal with these markets? Help them understand if you're going into private equity, and admittedly there are different asset classes, but if we're talking about the Conversus StepStone Private Markets Fund for example, or we're talking about private equity in general, how correlated is it to the rest of the market so that somebody understands that other reason why you want diversification?

BOB LONG: Correlation for private equity broadly defined would be about 70% to the public markets. In a fund that has some real estate infrastructure and private credit in it for example, you would see a little more diversification, a little less correlation. Target returns of course depend on the product, depend on the circumstances. I think for the investor

though, you need to ask yourself, are you being paid for the illiquidity that you're taking on? And importantly, the value proposition of the permanent capital vehicles, BDCs, tender funds, interval funds is they are semi-liquid, so you have liquidity typically quarterly, typically on about 90 days' notice. And you need to ask yourself, are you getting the return benefit from taking on some illiquidity in comparison to the public markets? And if so, then that can make sense for investors. But that's the question investors should be asking. Said differently, the value proposition for a semi-liquid product is to sit between your daily traded investments where you can get liquid every day but you may not like the price at which you can sell, and your 10 or 15-year marriage to the private equity fund. These permanent capital vehicles sit in between, and of course we think they provide an interesting complement to your portfolio from a risk-reward and liquidity perspective.

CHUCK JAFFE: They certainly open your portfolio up to a lot of investments that you're not necessarily looking at in all your classic stuff, and that's why I'm happy that you opened our eyes to all the private equity stuff today, Bob. Thanks so much for joining me.

BOB LONG: My pleasure.

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