

Investing in private market alternatives

Part II – The Importance of Rigorous Manager Research and ESG Considerations

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Summary

- Manager due diligence provides important information that contextualizes and adds confidence in an investor's expected performance outcomes associated with investments in private market alternative solutions.
- The scale and reputation needed to access deals, the performance impact of vintage year, and the complexities of product structures and fees are traits unique to private markets. They contribute to a far wider dispersion of manager performance than is typical in public markets.
- These characteristics underscore the importance of CIBC Asset Management's Total Investment Solutions (TIS) team, and the deep and extensive due diligence it performs on the private market manager universe. This includes an assessment of environmental, social and governance (ESG) factors, which can be an important consideration in this space.
- The rigour of this due diligence enables our clients to participate with confidence in private market solutions that fit with their investment goals and objectives.

Introduction

This is the second paper in a series that seeks to provide investors with a broad appreciation of private market alternative investment solutions. The first paper detailed the growth of private market alternatives, and the opportunities and risks they present to potential investors. The third installment will provide a deep dive into the characteristics of several private market asset classes and strategies. And the final paper will discuss the question of how much an investor should allocate to private market alternatives.

In this paper, we consider the central role of rigorous manager due diligence in appraising private market opportunities and risks. We then discuss ESG risks and opportunities inherent in private market alternative solutions.

Manager selection is an important determinant of an investor's experience for private market alternative solutions. The scale and reputation needed to access deals, the impacts of vintage year, the complexities of product structures and fees, among other unique traits that exist in private markets highlights the importance of a rigorous manager research. While many unpredictable factors can lead to performance dispersion—notably, the importance of vintage year—the unique risks associated with private market investing—including illiquidity, and lower transparency—means that a thorough manager research process is an essential part of confidently investing in this opportunity set.

Consistent with the approach of CIBC Asset Management's Total Investment Solutions (TIS) team in traditional public market solutions, our private market due diligence begins with a deep focus on best practices in a manager's organization and operations, and on the strength and consistency of a manager's investment processes. These include decision making, company research and selection, and portfolio construction. This due diligence is not a one and done snapshot. Instead, it is a continuous process that maximizes our ability to capture and understand any material changes within a firm's controls, systems, and processes, and to identify any potential headline risks. It provides our TIS team with a comprehensive understanding of the controllable factors in private market portfolio performance.

The following sections outline a non-exhaustive list of best practices that we explore in key categories of private market manager research.

The CIBC Asset Management approach to private market manager research

a) Organizational best practices

We assess managers to determine the degree to which they are investment-led as opposed to being focused on asset-gathering. Investment-led managers typically dedicate the majority of their time to better understanding the dynamics of the industries and markets in which they are investing.

Evidence we monitor encompasses:

- Specialization of responsibilities, including dedicated client portfolio managers that alleviate fund-raising burdens of day-to-day investors.
- Cultural cues that ensure investment performance drives organizational success.
- The origin story of the team, its track record, the thought diversity and experience of members, as well its outside reputation all provide further evidence of where a firm's focus lies.
- A virtuous circle of investment-led business success is often further demonstrated by low staff turnover, with any historical departures being idiosyncratic and not indicative of any endemic issues at the core of the firm, including uncertainty around profit distribution, employee ownership, and succession planning.
- A strong alignment of interest between a firm and its clients through an emphasis on investment results is also often demonstrated by key employees investing meaningful wealth in their own funds.

Private markets introduce a unique need for managers to gain access to deal sourcing, as well as the ability to obtain portfolio leverage. Developing scale and credibility creates a high barrier to entry that can eliminate many smaller organizations. We assess these criteria for each firm of interest.

Furthermore, we live in a complex world in which business lines inside organizations can intersect and create conflicts; for example, the activities of a firm's Private Equity team could introduce opportunities as well as risks for its Private Credit team. We seek to understand any potential conflicts of interest, and contextualize them in relation to evidence of a firm exhibiting an unequivocal focus on benefiting all of its clients.

b) Operational research

This is an important area for manager research. It has implications for valuation practices, the potential in opaque private markets for fraud, contingency planning, and other internal controls that present risks that can adversely impact investment returns and client confidence. We have an extensive checklist of indicators in order to understand whether operational risks at a firm may outweigh any of our other research criteria. These checklist items encompass the processes, controls and systems required to efficiently run an asset manager. We review these items for each firm against industry best practices. Where applicable, we take the opportunity to provide feedback on processes or systems that appear deficient and work with the manager to improve their infrastructure.

For private market managers, more emphasis is placed on evaluating valuation policies and processes given that pricing of private market securities can be subjective. In evaluating processes and policies, we want to ensure there are adequate controls and checks in place, and that an independent third party has been appointed to corroborate the firms' own valuations of securities, at least annually. In cases where a manager is overly reliant on manual processes to value private market securities, we suggest opportunities to automate to mitigate risk and operational costs.

c) Investment process research— decision-making

A formal process for decision-making is an important best practice. It alleviates the risk of emotional decision-making, or a breakdown in the ingredients—personnel and inputs—that have delivered past investment success.

Evidence we seek includes the following:

- Formal reports from deal teams that cover all historical investment ideas.
- Decision-making fora that exhibit consistent and diverse membership groups of experienced individuals who demonstrate a predilection for rigorous analysis of assumptions associated with any proposed investment.
- The control of individual biases within these processes.
- The rejection rate of ideas to better understand the rigor and credibility of these processes.

d) Investment process research— research/selection

We conduct a sampling of portfolio holdings in order to understand their consistency with the overall investment philosophy of the firm:

- For example, sponsor-backed and non-sponsor-backed private direct loans have associated pros and cons. Managers that believe in one approach over the other need to have no barriers—including size—to executing on their philosophy.
- We review each firm's ability to shape outcomes in its portfolio through an understanding of risk and reward for each of its holdings.

Reflecting low private market liquidity, a firm's research needs to demonstrate a thorough understanding of all relevant risk factors prior to executing investments. This requires that the quality of individuals responsible for conducting research is high, which we test by analyzing the rigour of assumptions associated with a sampling of holdings.

e) Investment process research— portfolio construction

Portfolios that lean relatively heavily on private market solutions should be sufficiently diversified to avoid any one event causing a series of material and permanent losses of capital in the portfolio. This is no different to portfolios built predominantly with public market solutions. This risk should be viewed in relation to the opportunities for outsized positive performance for private market investments. For example, in distressed funds an understanding and acceptance of exposure to downside risk is a prerequisite to investing in the mandate.

We believe that portfolios should be constructed to maximize efficiency in return streams. Valuation methods in private markets, however, limit the benefits of quantitative analysis that is standard in public market portfolios. As a result, a fundamental understanding of diversification across business models—as opposed to superficial industry rubrics—and other factors, such as inherent leverage at firm and fund levels, are important elements of our manager due diligence research.

Investing in private market alternatives—ESG considerations

Private markets exhibit several facets that present an opportunity for investment managers to effect change that produces better financial and non-financial outcomes for investors. These include relatively long investment horizons—in some cases in excess of 15 years. Long time horizons require investors be more aware than public market peers of how non-financial considerations may impact their holdings. They also offer significant opportunity for general partners (GPs) to work directly with the management of companies to advance ESG issues.

Private markets also present unique challenges to investors seeking to integrate ESG considerations into their investment processes. A lack of transparency with investee companies requires GPs to maintain a robust process of engagement and close working relationships with company management to understand attendant risks and opportunities. This makes ESG integration a vital component of all stages of investment activity, including during due diligence, investment holding periods, and investment exits.

The unique relationship of GPs, investors (or limited partners, LPs), and investee companies within private markets presents its own challenges for investors. There are often layers of due diligence needed with respect to ESG practices. It is important for LPs to identify each GP's approach to ESG considerations and how they engage with investee companies. The GP should have a formal process for identifying ESG risks in the due diligence process, and these risks should be outlined within the investment thesis. The GP should also clarify ESG expectations with portfolio companies and include these in the investment agreement. This will allow LPs an appropriate level of information and understanding to conduct their own assessment of both their GP's ESG integration capabilities and the level of ESG risk in the portfolio.

The GP is afforded an opportunity to work directly with company management to ensure appropriate ESG policies and procedures are in place and necessary resources are assigned. This includes establishing ESG key performance indicators for boards of directors and management teams to ensure incentives align to the management of ESG risks. This in turn adds value for investors by facilitating establishment of best practices in portfolio companies and a reduction in investor risk.

At CIBC Asset Management, all internal investment managers and approved sub-advisors—for both public and private markets—undergo an ESG due diligence assessment.

This assessment is performed by our dedicated investment professionals during the selection and onboarding phase. It is updated annually. It encompasses several factors that inform our view of the managers' ESG capabilities. These factors include: the approach to assessing ESG risk and its impact on investment decision-making, resources, stewardship activities; and UN Principles of Responsible Investment (UNPRI) assessments.

Conclusion

The complexity of private market alternatives, including opaque product and embedded fee structures, means that rigorous manager research provides important information. This information contextualizes and adds confidence in an investor's expected performance outcomes in this space. At CIBC Asset Management, we focus on organizational, operational, and investment process research to gain a deep understanding of the manager universe. We also work with approved sub-advisors to develop extensive partnerships that provide long-term benefit to our clients.

ESG is a key element of our manager research processes. Private markets offer the greatest opportunity to effect positive ESG change within portfolio companies; for instance, due to the ability of GPs to guide the ESG practices of portfolio companies. They also present significant challenges associated with a lack of transparency and disclosure. We continually work with our internal investment managers and approved sub-advisors on ESG best practices to ensure non-financial risk factors are fully considered in investment processes. This focus is expected to lead to better investment decision-making and superior results for our clients.

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Across a spectrum of investment solutions, we commit to robust research. Dedicated sector and regional analysts focus on industry research and security-specific idea generation. Our investment professionals leverage deep and diverse expertise by sharing proprietary research across asset-class teams. By sharing insight across asset class teams, we maximize opportunities to add value to our client portfolios.

Contact us any time

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