Screw Your Courage to the Sticking Place:

Continuing to Invest in Private Markets through 2023

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TIFF
INVESTMENT MANAGEMENT

I have a vivid memory of a colleague standing knee deep among those orange office moving crates methodically sorting papers into "keep" or "trash" piles. The head of the Private Markets practice for two decades at a non-profit advisory firm, she fished out a 2009 report titled "Will Private Equity Be Relevant Again?" The year was 2013, and Private Equity was at full momentum on a run of outperformance that would only cool in the back half of 2022.

She laughed – and put the report in the "keep" pile.

Why did she laugh? Because she knew – as Lady MacBeth expresses in the title quote – that a sound strategic plan *and* the courage of conviction to execute consistently are critical to long-term success. (Thankfully, this is all she and Lady MacBeth have in common.)

When investing, having moments of doubt is as inevitable as the challenging environments that spawn those doubts. In tough times, investment policy and asset allocation are the roadmaps that help keep investor focus on the long-term horizon, warding off the natural human instincts that can result in actions that harm the portfolio. With liquid assets, investors are often tempted to *sell* assets in an attempt to stave off further reductions in portfolio value. Instead, this locks in losses by converting unrealized declines into realized.

The opposite is true with Private Markets. In difficult markets, investors can't readily sell existing holdings and so are inclined to pause Private Markets commitments – they *stop buying*. However, committing to Private Markets during a downturn lets investors take advantage of mispricings as they entrust their capital to managers who aren't beholden to Wall Street's daily marks. Investors who reduce or even eliminate annual Private Markets commitments may assume a greater risk of giving up future return than those who continue to allocate steadily.

We believe that maintaining an allocation to Private Markets through a downturn can provide outsized, persistent return benefit. For years, we have espoused to our clients the importance of not trying to "time" Private Markets – and instead to commit consistently at a steady level year in and year out.

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Sometimes the most attractive times to commit are also the times with the greatest degree of uncertainty. In 2023, our view hasn't wavered.

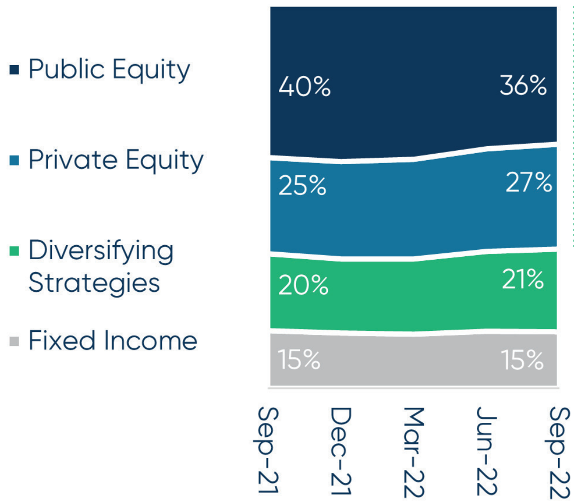
Private Markets in the Current Environment

The Roots of Most Fear: Denominator Effect and Reduced Access to Ready Liquidity

No matter how you look at it, 2022 was a terrible year for investing. Stocks and bonds declined simultaneously for the first time in 40 years – even safe harbors needed safe harbors. Economic and unpredictable non-economic events – the continued impact of the pandemic; war in Ukraine; etc. – combined to unleash rates of inflation not seen this century.

Markets responded accordingly. A standard, moderate risk posture of 65% Stocks / 35% Bonds would have resulted in a decline of 17% in 2022, taking a $100 portfolio to $83. With the value of Public Equities and Fixed Income falling so far and so fast, portfolios experienced the denominator effect: The shrinking asset base amplifies the weights of Hedge Funds, Fixed Income, and Private Markets. Privates are the only one of these broad asset class categories that are marked quarterly and on a lag, so delayed valuations further amplify their pricing mismatch versus the rest of the portfolio. This is how portfolios can have a pronounced overweight to illiquid assets seemingly overnight.

Exhibit 1 | Illustration of Denominator Effect on Asset Allocation by % Asset Class (2021 to 2022)[1]



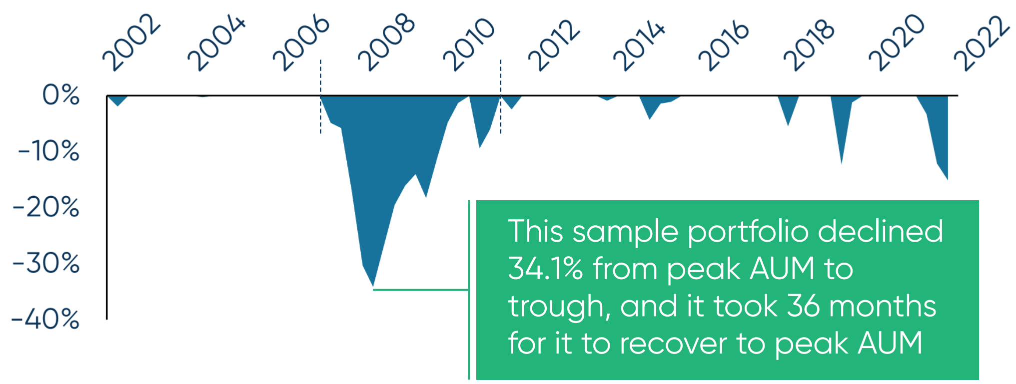
With exposure to Private Equity increasing by 2% and Public Equity decreasing by 4%, this portfolio experiences a **6 percentage-point swing within its exposure to growth assets** – driven purely by market movement

[1] Quarterly returns based on asset class indices: MSCI ACWI for Public Equity; Cambridge Associates Private Equity and Venture Capital Index for Private Markets; HFRI Fund of Funds Composite Index for Diversifying Strategies; and Bloomberg US Aggregate for Fixed Income.

Inflation compounded the impact of 2022's correction. It meant not only a reduction in return dollars, but also that those remaining dollars had greatly diminished purchasing power. Even the most fiscally conservative organizations strained to meet budgets approved a year prior. Liquidity was at a premium, making institutions sensitive to the impact on cash flows from capital calls from existing commitment vehicles.

Institutions concerned about the magnitude of the denominator effect should hold a few things in mind as they consider its adverse impact. First, the effect of negative markets is often temporary and can frequently be self-correcting – so long as investors don't turn unrealized losses into realized losses by selling assets at or near trough valuations.

Exhibit 2 | Illustrative Maximum Drawdown of a Portfolio that is 40% Public Equity, 25% Private Equity, 20% Diversifying Strategies and 15% Fixed Income[2]



Second, as noted above, organizations can't sell assets at depressed prices without locking in losses. This may make it less attractive to access instruments that typically provide ready liquidity. Organizations wanting to know how long they may need to hold onto assets at depressed prices should look to a maximum drawdown analysis of their portfolio. "Max Drawdown" quantifies the largest historical decline in portfolio value by percentage – and, equally importantly, the time in months that the portfolio was below peak asset value, where a sale of assets would crystallize a loss. Ideally, this analysis has been conducted on possible asset allocations *before* a target allocation is adopted, to ensure that drawdown magnitude and duration are within an institution's risk and liquidity tolerances. Then it is a matter of continuing to execute to plan to resist the tendency to indulge behavioral instincts in the heat of a market crisis.

[2] Maximum drawdown is the percentage decline from peak level of assets to trough and then return to peak assets. This example shows a sample portfolio with an asset allocation of 40% Public Equities, 25% Private Markets, 20% Diversifiers, and 15% Fixed Income.

Continued Commitments = Increased Likelihood of Outsized Benefit

With an inadvertent overweight to illiquid investments and concern about meeting existing obligations, who wouldn't be wary of continuing to add to Private Markets? History shows that investors who allocate to Private Markets consistently over time, including through downturns, are rewarded with outsized returns. Within Private Markets, some strategies benefit more than others.

This observation does come with a caveat, however. At TIFF, we regularly run Private Markets commitment pacing models that guide us toward an annual target commitment amount. The output of this model is only as valid as its assumptions, which include target asset allocation, total portfolio AUM, liquidity tolerance, and assumed growth rate of the portfolio.

There are two material considerations around target commitment amount:

1. Typically expressed in dollars, rather than as a percentage, the annual target commitment amount could – or *should* – be re-examined after market events like we saw in 2022. Continued allocations may need to be recalibrated to reflect the new reality for each institution and portfolio. Sometimes, this is merely a function of the reduced portfolio size, but often, institutions will experience either a temporary or permanent change to liquidity needs. Organizations may not necessarily need to change their annual commitment amount – but should verify that prior analysis still holds.

2. The target annual commitment amount is an *average*. You can't fund private investments at will – the typical investor can only commit to a manager when it comes to market with a new fund. The degree of uncertainty inherent to Private Markets fundraising may be heightened in difficult markets, as the pace of commitments, capital calls, and distributions slow. Don't be distracted by difficult market dynamics or you could miss out on some great vintage years – but also don't feel the need to meet the commitment target every year if there aren't a sufficient number of attractive opportunities coming to market.

The key takeaways here? So long as an investor is committing at a dollar amount that reflects any new and permanent enterprise realities, the investor should continue to allocate steadily to Private Markets. As organizations continue to commit to illiquids, they should maintain discipline, keeping up a pace necessary to meet average commitments targets over the long term.

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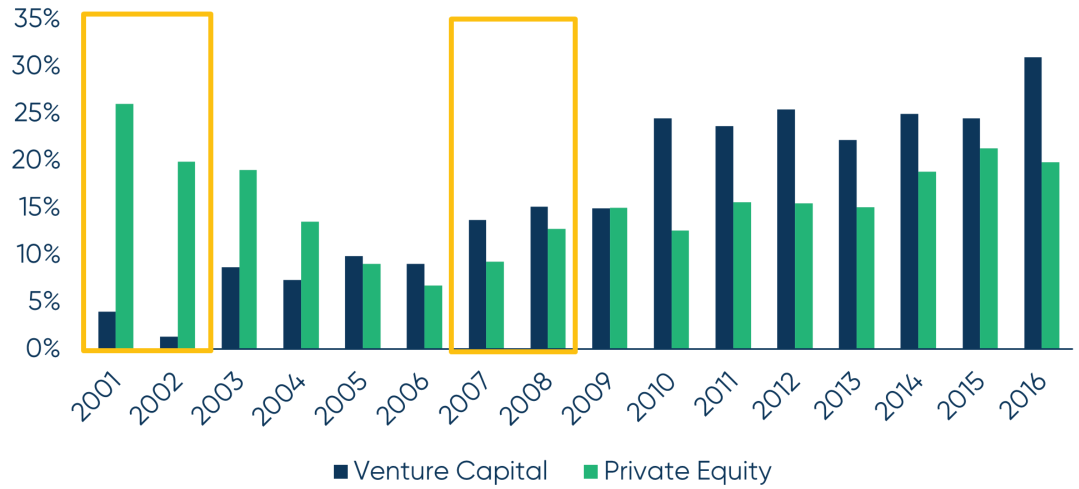
Historically, those who continue to fund Private Markets through a downturn tend to realize strong returns for those vintage years. Private Equity significantly outperformed in the vintage years that captured the burst of the dotcom bubble. Since 2008, outperformance has been weighted to Venture Capital over Private Equity, with the trend continuing through 2016 (the most recent year with enough return data to assess the vintage year).

Exhibit 3 | Historical IRRs by Type of Fund and Vintage Year[3]



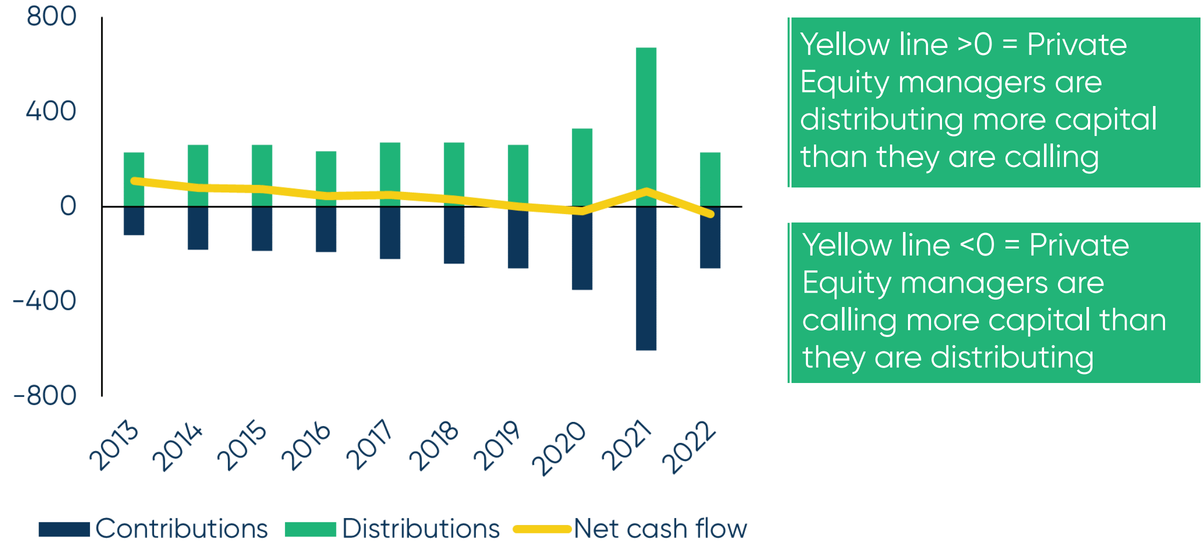
In turn, both Venture and Private Equity have significantly outperformed other segments of Private Markets (Real Assets and Private Credit), as well as public equities, over these – and longer – time periods.[4]

[3] Cambridge Associate Venture Capital Index and Benchmark Statistic Based on data compiled from venture capital funds, including fully liquidated partnerships; Cambridge Associate Private Equity Index and Benchmark Statistic. Based on data compiled from private equity funds, including fully liquidated partnerships. Internal rates of returns are net of fees, expenses and carried interest. CA research shows that most funds take at least six years to settle into their final quartile ranking, and previous to this settling they typically rank in 2 to 3 other quartiles; therefore fund or benchmark performance metrics from more recent vintage years may be less meaningful. There can be no assurance that any TIFF strategy will achieve its objectives or avoid substantial losses.
[4] Cambridge Associates benchmark reports, September 30, 2022.

Cash Flow Trends Neutralize Investor Liquidity Pressure

In periods of crisis, cash flows tend to contract, as both capital calls and distributions decline. This trend has persisted through multiple market cycles – and despite crises that are driven by wildly differing catalysts.

Exhibit 4 | Trends in Global Private Equity Cash Flows (2001 to 2022, in $B)[5]



In effect, Private Markets' tendency to self-regulate in a downturn may mitigate the liquidity pressure that investors are likely experiencing elsewhere in their portfolios and at their organizations. Over time, we've seen many institutions assume that capital calls will continue at pre-downturn rates, while distributions will drop to zero; this leads those institutions to slash their Private Markets commitments and effectively skip those vintage years. History shows us that their fear is overblown.

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Distributions do indeed slow as M&A and IPO activity drops, but capital calls also slow, as managers become more cautious and as the bid-ask spread between buyers and sellers widens at least for a time. More neutral Private Markets cash flows, with both slower capital calls and distributions, may alleviate the prospect

[5] Data: Burgiss, UBS. 2013 through 2021 are full calendar year data; 2021 through September 30, 2022, the most recent available data.

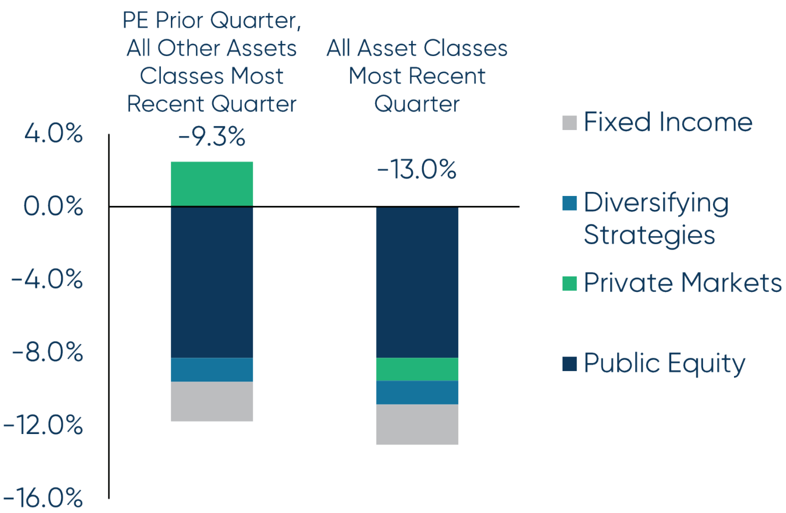
of additional liquidity pressure and allow for investors to continue to make steady commitments through a downturn.

Private Markets in Any Market Environment

Reduced spending volatility and optimized exit timing

Some of the peskier characteristics of investing in illiquids provide overlooked benefits, particularly in the short term. The first challenge is that holdings aren't priced daily, but are instead marked to market, with valuations available typically a full quarter – or two – after marketable peers report. Additionally, changes in Private Markets valuations tend to be less volatile than public valuations from one quarter to the next for a variety of reasons. In periods of distress, these asset pricing factors help smooth returns. The larger the allocation to illiquids, the greater the smoothing effect. The impact on annual returns can be significant. Take this hypothetical portfolio with a 25% allocation to Private Markets:

Exhibit 5 | Impact of Lagged Private Markets Valuations on Total Portfolio Return (% return, 1 Year through September 30, 2022)[6]

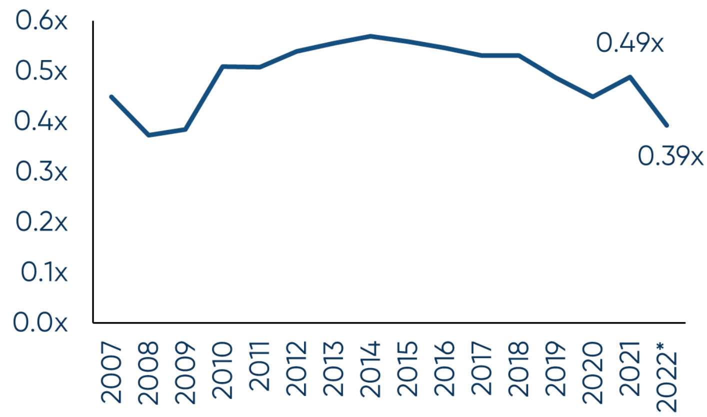


For a single year of total portfolio returns, the portfolio on the left, where Private Markets valuations are from a quarter earlier than other asset classes, had performance that was *370 bps higher* than the portfolio where all asset class returns were from the same quarter. For a non-profit with a typical three-year spending rule, this synthetic smoothing of returns is diluted over a 12-quarter average, but the impact is directionally the same. Reduced return volatility translates to reduced spending volatility. This positive attribute is diminished over a long-term horizon, but it can certainly help mitigate whipsawing of short-term returns.

[6] Quarterly returns based on asset class indices: MSCI ACWI for Public Equity, Cambridge Associates Private Equity and Venture Capital Index for Private Markets, the HFRI Fund of Funds Composite Index for Diversifying Strategies, and Bloomberg US Aggregate for Fixed Income. "PE Prior Quarter, All Other Asset Classes Most Recent Quarter" (Column 1) shows year-over-year return with data for Q3 '22 for Public Equity, Diversifiers, and Fixed Income, with Private Equity updated through the prior quarter. "All Asset Classes Most Recent Quarter" (Column 2) shows year-over-year return where all asset classes have return data as of Q3 '22.

Another valuable feature of Private Markets? The flexibility managers have to hold assets until they can be monetized for an attractive exit price. The degree of discretion that Private Markets managers have over the life of their assets introduces unpredictability to long-term portfolio planning. But it provides an upside in market downturns – one that managers took advantage of last year.

Exhibit 6 | P/E Exit-to-Investment Ratio (2007 to 2022)[7]



In 2022, the number of exits relative to investments dropped to the lowest level since 2008. Using the Great Financial Crisis as a reference, managers held firm on pricing for 2 years, resuming exits in 2010 within a year of public markets beginning their recovery. The ability of Private Market managers to defer exits when marketable peers may be forced to be price takers can help preserve value in investor portfolios.

TIFF Private Markets in the Current Environment

Expertise & Philosophy Align With Current Opportunity Set

Longtime members will be familiar with our view on how valuable market corrections are to long-term investors. Painful as they are at the total portfolio level – and for the institutions needing to spend endowment dollars in the short term – the repricing of assets that comes with market dislocations creates investment opportunities. Members will also be aware of our investment philosophy, which maximizes equity exposure to meet members' risk tolerance. Then, within equities, we seek to optimize the mix of exposure through public or private, favoring Private Markets within the bounds of liquidity limits. In environments like what we are experiencing in 2022 and 2023, we roll up our sleeves to find the most attractive illiquids mispricings.

Also in our favor: At TIFF, our Private Markets philosophy focuses on smaller, specialist

[7] "2022 Annual US Private Equity Breakdown," PitchBook, February 23, 2023. *Data as of September 30, 2022.

early-stage venture capital and lower middle market private equity managers targeting smaller or less mature businesses:

Exhibit 7

US Private Equity Fundraising by Fund Size (2012 - Q4 2022)[8]

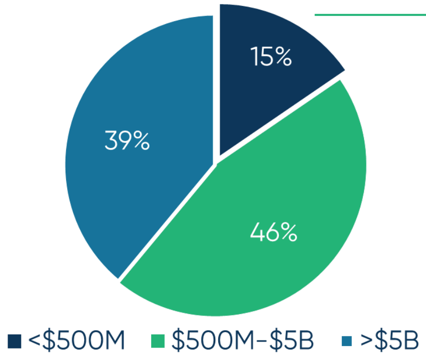
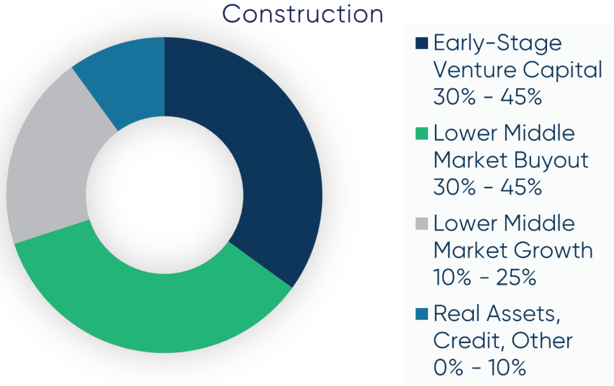


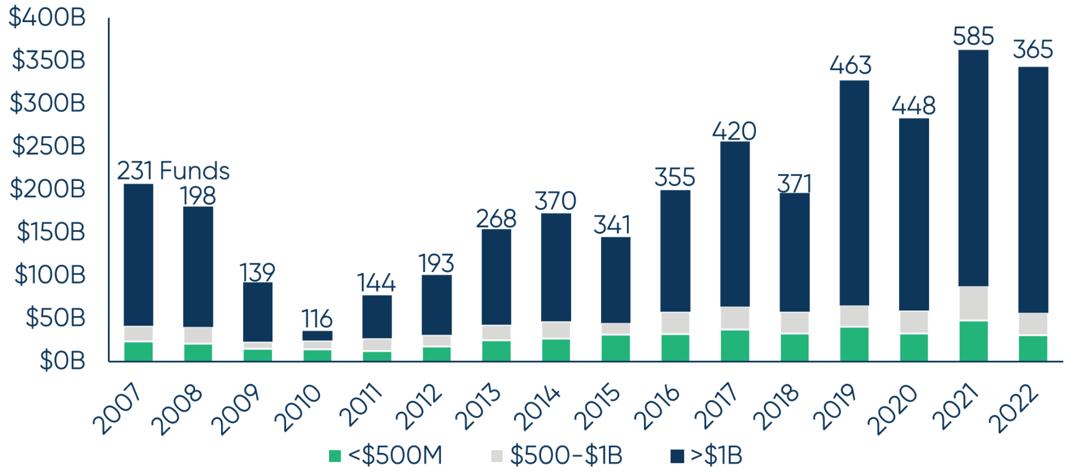
Exhibit 8

TIFF Private Markets Portfolio Construction



Throughout 2022, investors who continued to allocate to Private Markets gravitated to the largest funds – so much so that market share of large funds hit a 15-year high.[9] The big funds got bigger, and competition has continued to increase for larger funds, making it harder for big firms and their investors to take advantage of buying opportunities in this downturn.

Exhibit 9 | Private Equity Private Capital Fundraising Activity (2007 to 2022; $TN)[10]



On the flip side, funds with less $500M in capital saw the largest decrease in fundraising.[8] Historically, Private Equity managers with ≤$500M have received

[8] Reflects company and fund level data from over 1300 privately owned companies and over 2600 private equity funds from 2008 through 2022. Pitchbook Q4 2022.
[9] "Private Markets Turn Down the Volume: McKinsey Global Private Markets Review," McKinsey & Co., March 2023. Data: Preqin. Excludes Secondaries and Fund of Funds to avoid double counting of capital raised.
[10] "2022 Annual Global Private Market Fundraising Report," PitchBook, February 23, 2023. Data as of September 30, 2022.

less than 15% of total PE fundraising dollars; the companies those smaller managers are targeting represent 80% of US companies, while larger funds make up 85% of fundraising but only targeting 20% of US companies.[11] This suggests a persistent area of great inefficiency in Private Markets, which in turn creates potential for significant outperformance. In today's market, we're seeing the same capital-opportunity mismatch in the smaller end of Private Markets, as well as a massive, overfunded universe of larger PE firms for smaller funds to sell their companies to when they're ready to exit.

Our area of expertise in Private Markets varies from our competitors' and from where investors are currently allocating. In 2023, we expect to have less competition for opportunities with smaller managers and in co-investments when we find them. This improves our chances of favorable partnerships, the likelihood of receiving desired allocation sizing, and our ability to negotiate strong terms.

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Conclusion

The mispricings created in the current environment can result in attractive opportunities for those who continue to invest in Private Markets. Investors who continue to grow or maintain their Privates Markets exposure have the potential to realize outsized returns over the long term. Downturns also tend to discourage investors whose other assets are under stress and may worry about incurring additional liquidity risk. Less competition for access to capacity-constrained managers – particularly with those overseeing funds with ≤$500M - is an additional benefit. This portion of Private Markets – smaller managers – is TIFF's sweet spot, with our expertise honed over

[11] Reflects deal-level data from more than 15,000 buyout transactions from the mid-1990s through 2022. Sources are Burgiss and the paper "Private Equity Portfolio Companies: A First Look at Burgiss Holdings Data," by Brown, Harris, Hu, et al.

three decades. In addition to the potential for improved access to highly sought-after managers and enhanced likelihood of capturing alpha, the nature of Private Markets offers attributes that are protective in difficult markets: Lagged returns help smooth portfolio returns and spending, and discretion over exit timing allows managers to prevent unrealized declines in valuations from becoming realized. At TIFF, we are excited about the opportunities in Private Markets that the market is offering – and excited about how investors can benefit over the long-term life of these investments.

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