

## Q&A: Cambridge Associates and LAVCA

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We recently sat down with David Druley, leader of Cambridge Associates' global pension practice, Aaron McKay, a private investments specialist and leader of Cambridge's Latin America initiative, and Andrea Auerbach, global head of private equity research and co-investments, to ask some questions regarding trends with global pension investors and implications for Latin American investors.

### **LAVCA: What are the recent trends you are seeing with large pension LPs?**

**David:** The general trends in pension investing continue. Globally, pension plans that continue to accrue benefits, or are significantly underfunded, are seeking ways to increase their return on investment. As a result, many large pension plans have increased their allocations to private equity, venture capital and private real assets. This trend has been accentuated by the broad view that global equities are overvalued, thus there is a need to move funds to investments with a greater expected return. Low sovereign bond yields and tight credit spreads over the past 5 years, have also led pension plans to invest more in private credit strategies that generate a higher cash-on-cash yield, and have higher expected returns. The supply of these private credit investments has increased, as banks have pulled back from lending due to tighter regulatory constraints. Finally, given the low fee structure, there have been significantly more direct investments and co-investments in recent years as pensions look for ways to put investment dollars to work in private investment strategies in a more cost effective manner.

### **LAVCA: U.S. and Canadian pension funds have been investing in private equity for decades. How has their strategy evolved over time? From your point of view, what elements or conditions need to be in place for pension funds to effectively co-invest and/or directly invest in PE?**

**Aaron:** From what we have seen, there is no simple formula as to the amount of time investing in privates and the number of investment staff needed before a firm begins investing in directs and co-investments. What is clear is that making direct investments or co-investments requires more people, more experience, and staff with additional skill sets. Pensions *generally* graduate into making directs/co-investments when they have staff that have completed at least one full cycle of private investment experience (and have ideally invested through multiple economic cycles) and the assets they need to invest are so large it becomes difficult to meet exposure targets simply through fund commitments. But I'd like to reiterate that, there is no set model here. For example there was a recent article in *Private Equity International* about a very large North American pension fund who actually *began* investing more in directs than in funds, with success in the U.S. and Europe. However, for Asian markets, which are less familiar and more complex, they are anticipating that the majority of their private investment will be via funds. Client-specific goals, capabilities, and of course, the market, drive strategy more often than not.

### **LAVCA: How should Latin American Pensions think about direct and co-investment strategies?**

**Aaron:** As I said before, it is helpful to have an investment team that has experienced (in their current or previous jobs) a cycle or two as an investor in private investments funds, and in some Latin American countries, like Colombia, the current regulatory environment has not been in place much longer than the life cycle of a single private equity fund! Having gained this experience, many investors who are new to

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direct and co-investing start with co-investing as a first step as it allows them to work with a General Partner they already have a relationship with. In general, this allows the investor to leverage the GP and learn alongside them. In direct investing the investor has to do all the work and many investors don't yet have either the staff, skills, or direct investment expertise.

In addition to potentially superior net-to-LP returns, participating in a GP's co-investment program has the potential to provide an investor with qualitative benefits such as the opportunity to gain expertise, enhance its reputation as a savvy, strategic partner, and strengthen its relationship with the sponsor, which may result in greater access to that GP's funds. Co-investments can also be a way for investors to initiate a relationship with a new GP. In either case, investing alongside a sponsor is an opportunity for more rigorous due diligence and insight into the GP's processes and investment behavior, which will inform the investor's decision on whether to invest in the GP's future funds.

Overall, the notion of "being a good LP", that is, working well with GPs, is an important item for newer investors in private investments to keep in mind, regardless of whether a fund or co-investment strategy is being pursued.

***LAVCA: Can you tell us more about why a co-investment strategy could be appealing to a Latin American Pension?***

***Andrea:*** As pension plans seek additional return, co-investments present themselves as intriguing opportunities for a number of reasons. Due to a lower fee structure, co-investing theoretically offers investors cost advantages when compared to more traditional limited partnerships. In addition, co-investments have shown the potential to achieve returns that outpace private investment funds. Co-investments can also mitigate an overall private investments portfolio's J-Curve (the J-shaped dip in performance in the early years when fees and drawdowns exceed distributions from the investment). Cambridge has recently published a research report that focuses specifically on framing the opportunities and common pitfalls of co-investing. This report leverages our aggregated data on co-investments and funds generating co-investment opportunities. Our analysis suggests that individual co-investment outperformance is not just hypothetical, it is, in fact, possible.

***LAVCA: You mention the "common pitfalls of co-investing." What advice would you offer Latin American Pension funds who are interested in pursuing a co-investment strategy?***

***Andrea:*** Implementation is trickier than it may seem at first glance. It should be noted that there is an observable pro-cyclical risk to co-investment as the volumes of co-investment opportunities tends to increase with valuations. Success in co-investments across every asset class relies on retaining expert resources, either internal staff or external advisors/ investment managers. A successful co-investor will also establish internal processes to facilitate timely investment decisions, as well as effective investment monitoring and performance measurement. Co-investment is labor intensive and requires significant expertise as well as a clear understanding of what types of co-investments are likely to succeed. It is wise for investors to co-invest with GPs on which they have done due diligence and in which they have conviction—as they will likely need to rely heavily on the GP's due diligence. Our advice is also for investors to focus on investments within each GP's stated strategy, or "strike zone," to avoid adverse selection. Whether it is investment in limited partnerships or co-investment, the most successful allocations are diversified across geography and vintage year. Finally, to enhance the probability of

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success, investors that choose to pursue a direct co-investment program should think carefully about program goals and set realistic expectations.