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Q&A: Portfolio Advisors' Brian Murphy On The Advantages of A Private Markets Platform

Editor's note: *Most private markets firms reference their platforms as a source of competitive advantage, but few have established the kind of interconnected, mutually-supporting web of strategies and services as Darien, Connecticut-based* ***Portfolio Advisors, LLC*** *("PA"). This was done for many good reasons, notes Managing Member Brian Murphy, and delivers multiple benefits including the ability to be patient when necessary, innovative when an opportunity to expand appears, and cycle-agnostic throughout.*

FINalternatives: Portfolio Advisors has substantially grown its sponsored funds AUM over the past few years while largely staying under the radar. Tell us a bit about the company and how it has shifted from a more advisory focus to being a leading private markets specialist.

Murphy: In the early days, our founders preferred to grow quietly out of the limelight. It worked – PA focused on a handful of advisory clients and relied on our results and their word-of-mouth recommendations to grow. Our growth and success with our advisory clients led to new opportunities for the firm.

We consciously pivoted from our pure advisory roots and into funds almost two decades ago, not randomly or by accident, but because it is a much more scalable and dependable business model. Long-term capital commitments generate a much more predictable revenue stream, allow us to recruit the right people and incentivize them the right way, and increase our skin in the game, so we concentrated first on developing unique products where we knew we could succeed and get attention, slowly build a record and build the trust of investors. It's worked very well.

The alternative investment landscape in general, and the private equity space in particular, have changed since the financial crisis. How is PA adapting to the new realities of high valuations and oodles of dry powder? Are there still pockets of value?

One of the key advantages to a firm like ours is that while we don't really have the luxury of sitting on cash, we are in an industry that benefits from dollar cost averaging and has long investment and realization cycles. That forced discipline means you are in the market during both swoons and surges, and allows you to do well over time. During the financial crisis, for example, we could take advantage of major market dislocations. It's always relative – some crisis-era funds looked awful on an interim basis, but will ultimately turn out to be decent performers for their investors because they were diversified from a vintage year perspective and a portion of their capital was deployed at a time when everyone else was running for the exits or triaging pre-crisis deals.

The basic reason this asset class outperforms is that the private equity industry is focused on those sectors of the economy that are growing the fastest. There is real skill in structuring deals, changing management, executing accretive M&A, improving operations, applying prudent financial leverage and creating attractive exits. When all of these factors are combined with consistent growth, good things can happen.

Since we're required to invest, the question becomes how to do it in the best way. For instance, secondaries are a great complement to the fund-of-funds and advisory primaries business; typically we have an opportunity to buy below fair market value, which provides the ability to lower risk regardless of market pricing. The co-investment business also provides the opportunity to benefit from a natural fee arbitrage – selectively targeting investments with outperforming managers in their areas of expertise.

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Granted, there is a lot of dry powder sloshing around – a function of monetary policy as much as the popularity of alternative investments – and there is a lot of experience and competition, all of which tend to drive down returns. But over time, the best players who are best positioned still outperform. Managers buying average companies for premium market multiples are probably going to fare poorly; those deploying capital more intelligently will do better. Will it be 25% annualized? Probably not. But it might be 10%-20%.

What is your view on open-ended funds and can you describe investor interest in this space? Explain the decision to head down that route as well.

Just as Portfolio Advisors evolved from an advisory business model to a fund-of-funds model, we have seen the need to develop products that are open ended to meet investor appetite for shorter investment lock-ups. We first encountered interest for an open-ended fund concept during our marketing efforts in Japan. At the time, many Japanese investors told us that their boards couldn't go for locking up capital for 10-15 years – they needed 5-year or even shorter cycles – and were more interested in current income than capital appreciation. They were willing to sacrifice some longer-term return in exchange for higher liquidity and current income. For this type of investor, it became clear that what made the most sense would be an open-ended structure so they could be out in five years if necessary. From an investment standpoint we think some credit-oriented products are a great fit for an open-ended fund. We see a great opportunity to combine current income credit secondaries with a credit co-investment strategy, which should help to mitigate reinvestment risk. When properly structured and invested, this type of product will offer safety and stability from a cash flow perspective (especially with a mix of floating-rate debt investments) and also meet the shorter duration objective. As it turns out, the open-ended concept with these characteristics has been attractive to U.S. and European clients as well.

There has been a lot of commentary recently about the imminent demise of the fund-of-funds model. What's your take?

What we've seen in the funds-of-funds space has been a natural evolution as the market matures. As allocation percentages increased, larger dollar amounts were put to work in the segment, and eventually it started making sense to do things like build in-house teams and shift exposures to other areas. But many family offices, small endowments and the like can't grow their allocation sufficiently to justify the cost of in-house management, so they still need the fund-of-funds solution. It's hard to build an internal team at smaller LPs with, say, a $10 million allocation to private equity, because you need $500,000 or $1 million to support a small team and that translates to a $100 million allocation to make it work.

On a related note, I'd add that our menu approach allows us to customize solutions and stretch the duration of our relationships with our fund-of-funds clients. It gets back to the platform – we can modify those relationships as we go, and provide tangential solutions to requirements elsewhere in the client's portfolio. PA is differentiated in this sense.

Interest in private credit has exploded in recent years. What's PA doing in this fast-growing segment? How do you see this niche in particular handling the strategic shift in monetary policy currently underway?

From a vehicle perspective, we have entered the private credit space in a very measured manner, despite being a credit fund investor for more than 20 years. First, we entered credit secondaries and co-investments as natural extensions of what we were already doing in the primary investing area, and then we went into direct mezzanine lending through a lift-out of a team from Credit Suisse. Our next step is senior credit – we will focus on loans and senior tranche debt. It is a good example of our overall approach. The various parts and players in our platform help us identify spaces where we can generate attractive deal flow and returns to investors, and we roll those strategies out as appropriate.

The PA platform is differentiated in that it operates across private equity, secondaries, co-investments, real estate and private credit both here and abroad. What are the advantages to such a setup? How does it differentiate the company?

The platform is really about relationships, and those relationships are a key advantage across the board. For investors, it means we can provide a diversified portfolio that works in different conditions and cycle stages.

As managers, it means much larger relationships with our GPs and LPs, more cost-effective solutions, and a steady flow of ideas for new strategies that might be complementary to our existing product set. In terms of risk mitigation, the fact that we're already working with these LPs and GPs means due diligence is more efficient. And for PA the company, the platform means a diversified revenue base, the ability to be flexible in our pricing as necessary, and it makes us a better investor because of the tremendous market insights and knowledge it provides. The platform we've steadily built over the years has become a key competitive driver of our growth.

Large investors such as pension funds have been increasingly questioning fee structures across a range of alternative investment vehicles. What do you think the future holds for traditional private market fund fees? Is it really just about performance?

We're not surprised by the push on the part of large investors to get better terms on their investments. As any industry expands, competition increases and pressure on fees is one consequence of that – particularly in low-yield environments. Pressure on fees will continue for the foreseeable future. The trick will be in how managers handle the compression operationally, and to what extent investors understand that in this business, the lowest-priced option sometimes turns out to be the most expensive in the long run.

Looking out across PA's strategies, what holds the most promise for 2018, and what risks do you see on the horizon? What are the pundits getting wrong?

One thing always stays true in this business: It's easy to believe you can time the markets. But that's a fallacy, particularly when you're speaking about funds with very long lock-up periods. Most of the vehicles we create will hit a downdraft at some point in their lives, maybe two…it might happen early, toward the middle or near the end, but it will probably happen. We can't invest successfully trying to time the market. We assume we will commit 100% of the allocation from our LPs, and then tilt our portfolio to macro and micro views accordingly, but we're never so caught up in this or that cycle that it changes how we work. As long as our managers are invested in the fastest-growing spaces, as long as we're able to consistently buy at a discount or favor better managers, we will be able to ride it out. Yes, it's a high-priced market heading into the new year and valuations are stretched, not only in private markets but also in traded equity and debt, but that just means we have to remain disciplined and stay the course. If our previous experience is any guide, strong results are likely to follow.