TRUE NORTH INSTITUTE

An Investment Letter For True Long-Term Investors: Q2 2024

This is our inaugural quarterly newsletter. The aim of this is to arm the Chair of Institutional Investors' Investment Committees and the Chief Investment Officer with possible agenda items to be addressed in the upcoming investment committee meeting. We assume this audience comprises mostly true long-term investors and the topics for discussion would only be those with long-term consequences, including near-term actions which could have long-term consequences.

Elephants in the Investment Committee Boardroom

We surveyed 20 CIOs, from some of the most highly respected endowments, foundations, and sovereign wealth funds, on what issues hit highest on the agenda going into the next quarterly IC meeting. Their answers varied hugely, with no dominant topic and few duplicate entries. The ranking is ours, based on which topics on this list have come up most in Partners Capital client IC meetings.

1) The long-term prospects for private equity
2) Artificial Intelligence: investment opportunities and the impact on our investment process
3) Illiquidity management: managing PE capital call cash requirements as distributions dry up
4) Alpha from public equities: active vs passive debate
5) Rethink our ESG Policy (making it more practical)
6) China allocations (including portfolio impact assessment on worst case scenario)
7) Policy on the role of politics in investment strategy
8)Policy on fees paid to asset managers
9) Endowment team resources, remuneration and alignment
10) Rethink portfolio performance benchmarking policy

Long-Term Performance

Fiscal Years		FYTD estimate	3-Year Peformance	5-Year Performance	10-Year Performance
		Jun 23 - Apr 24	Jun 21 - Apr 24	Ju 19 - Apr 24	Jun 14 - Apr 24
Top 12 Endowments	Harvard, Yale, Stanford, UVA, Penn, Brown & others. (See note 1)	5.7%	1.4%	10.2%	8.9%
NACUBO Cohort	(>$1B AUM)	6.5%	2.1%	8.7%	7.3%

Calendar Years	Index Name	CYTD estimate	3-Year Peformance	5-Year Performance	10-Year Performance	10-Year Forecast (2)
		Jan 24 – Apr 24	Apr 21 – Apr 24	Apr 19 – Apr 24	Apr 14 – Apr 24	2024-2033
NACUBO Cohort	(>$1B AUM)	2.6%	5.7%	9.4%	7.6%	-
70/30 Equity/Bond Index	70% MSCI ACWI / 30% Barclays US Treasury 5-10 Year	3.3%	3.2%	7.2%	7.1%	6.9%
Asset Class Returns						
Fixed Income	Barclays US Treasury 5-10 Yr	(3.8%)	(4.1%)	(0.5%)	1.0%	4.3%
Liquid Credit	Barclays Global Corporate BBB	(1.4%)	(1.8%)	1.5%	2.9%	7.0%
Private Credit	State Street Private Debt	3.5%	8.5%	8.8%	8.5%	9.5%
Public Equities	MSCI ACWI	6.5%	6.2%	10.3%	9.6%	8.0%
Leveraged Buyouts	State Street Leveraged Buyouts	3.4%	10.7%	13.9%	12.6%	11.5%
Venture Capital	State Street Venture Capital	1.0%	0.1%	14.9%	13.6%	13.5%
Hedge Funds	HFRI Conservative	3.2%	3.7%	5.0%	3.6%	7.3%
Real Estate	Preqin Real Estate Opportunities	(0.7%)	10.3%	8.2%	9.6%	10.5%

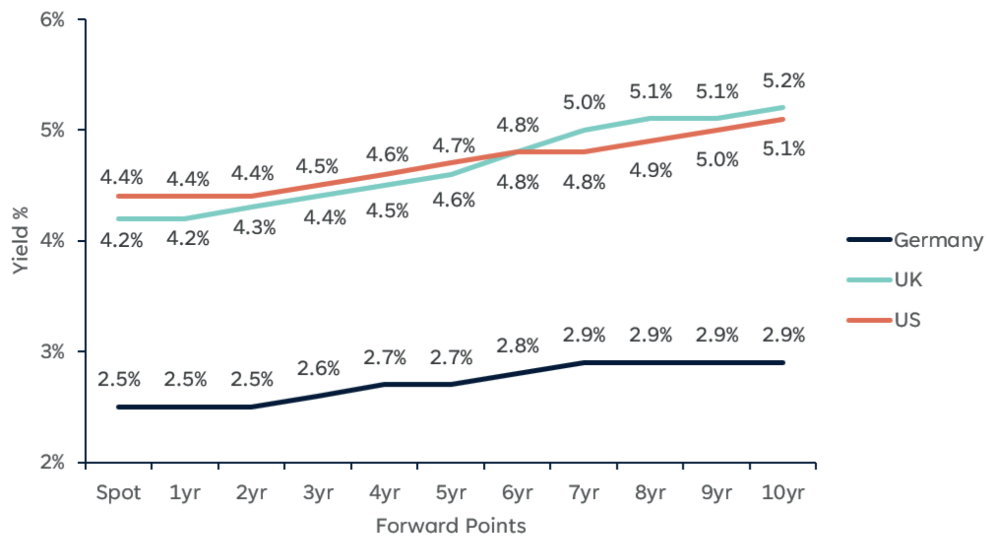
Notes:
1. Includes reported results through 30 June 2023 and market index based estimates for July 23 to April 24. Includes Brown, Columbia, Cornell, Dartmouth, Harvard, MIT, Notre Dame, U Penn, Princeton, Stanford, University of Virginia (UVIMCO) and Yale.
2. Partners Capital 10-year forecast net returns (see bar chart at back). NACUBO 10-yr forecast return is based on FYE23 asset allocation of the top 12 endowments listed above and Partners Capital 10-year return forecasts. Assume 60% Buyouts and 40% VC as per NACUBO >$1B AUM cohort.

The Only Macro Debates Worth Having Today

The IC Chair can usefully guide macro discussion with their committee members by establishing what macro topics are worth debating in the investment committee boardroom. Valuable airtime can be wasted on attempts to forecast the unpredictable and discuss events that may not have any material long-term impact on investment performance. It is our view that portfolios should be positioned to arrive on the other side of a deep recession in the best shape without trying to time equity exposure in advance of a recession prediction. Historically, geopolitical events have rarely had any significant long-term impact on financial markets. We also find very few action implications from forecasting central bank dot-plots on future rate cuts or rises.

The single biggest topic that may be worth debating that materially influences long-term strategy is **long-term inflation and interest rate forecasts** as influenced by burgeoning government deficits and investment crowding behind the three key megatrends: supply chain resilience, energy transition and AI. Annual investment in these three will be inflationary in the near term and productivity and growth enhancing in the long-term. Below, you can see what markets are pricing in as 10-year Treasury yields over the next 10 years.

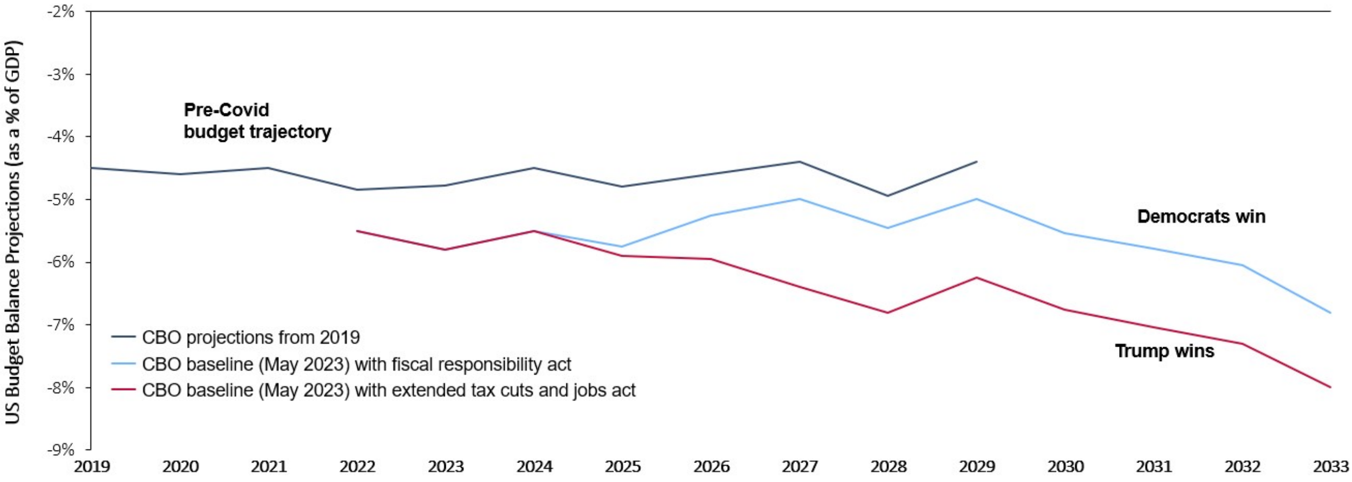
10yr Government Bond Yields are expected to gradually increase over the next decade to c. 5% in US/UK and c. 3% in Germany.



Source: Bloomberg 20 May 2024

Some elections can also change the relative attractiveness of different asset classes such as the current US election. One of our favourite macro research firms, BCA, has estimated the spending and deficits from a Trump vs Biden presidency, without commenting on the likely outcome.

Projections from the CBO suggest that Trump will expand the deficit more than a Democratic President
(US budget balance projections as a % of GDP - the lower the line, the larger the deficit)



Source: BCA Research, CBO. This research assumed that the Democratic nominee was Biden, so does not account for any change of approach by the eventual Democrat nominee

China relations is a pertinent topic to debate where sentiment has clearly shifted away and some CIOs of leading endowments are being asked to include a China risk scorecard with their boards at each quarterly/semi-annual meeting (KKR endowment survey Sept 2022). This KKR survey of 30 large endowments highlighted a huge range in China exposure from 3% to 20% of total assets for different endowments.

Institutions Doing Interesting Big Things

The University of California's $100B AuM pension and endowment funds will stop investing in hedge funds in favour of private credit.

Over 25 institutional investors, led by Texas Teachers, call on hedge funds to have cash return hurdles over which their performance fees are charged (vs. zero hurdles at present for most hedge funds).

Private Equity firms acquire infrastructure firms. Blackrock acquires GIP (Global Infrastructure Partners) and General Atlantic acquires Actis emerging markets infrastructure firm. "The unprecedented need for digital infrastructure, for upgraded logistics hubs, and for decarbonization and energy security – coupled with record high government deficits means that private capital will be needed like never before," Fink and BlackRock President Rob Kapito said. "This will be one of the fastest-growing areas of our industry over the next 10 years." General Atlantic's acquisition of Actis adds to their credibility in the energy transition space which is a strategic priority for the firm.

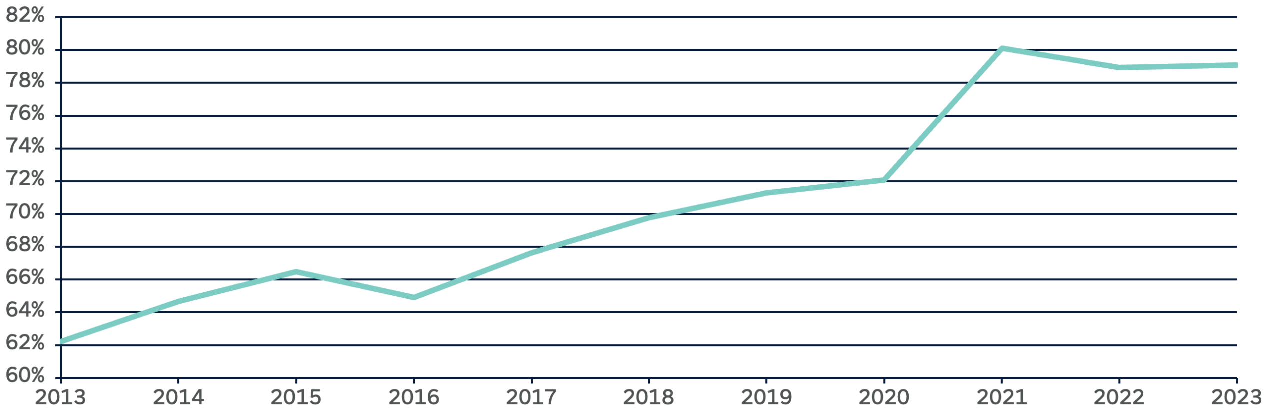
Largest OCIO mandate in history. UPS has hired Goldman Sachs Asset Management to provide OCIO (outsourced CIO) services for the transportation company's U.S. and Canadian pension plans, totalling $43.4 billion in assets, one of the largest pension OCIO mandates ever, followed by BlackRock's $30.5 billion OCIO mandate with British Airways, and GSAM's $28.8 billion mandate with BAE Systems.

Asset Allocation Trends

There is a clear long-term trend of increasing overall portfolio risk in endowment portfolios as measured by Partners Capital's equivalent net equity beta (ENEB).

Average ENEB for the top 12 US university endowments has been steadily increasing since over the last 10 years from 62% to nearly 80% today.

Average ENEB for Endowment Sample

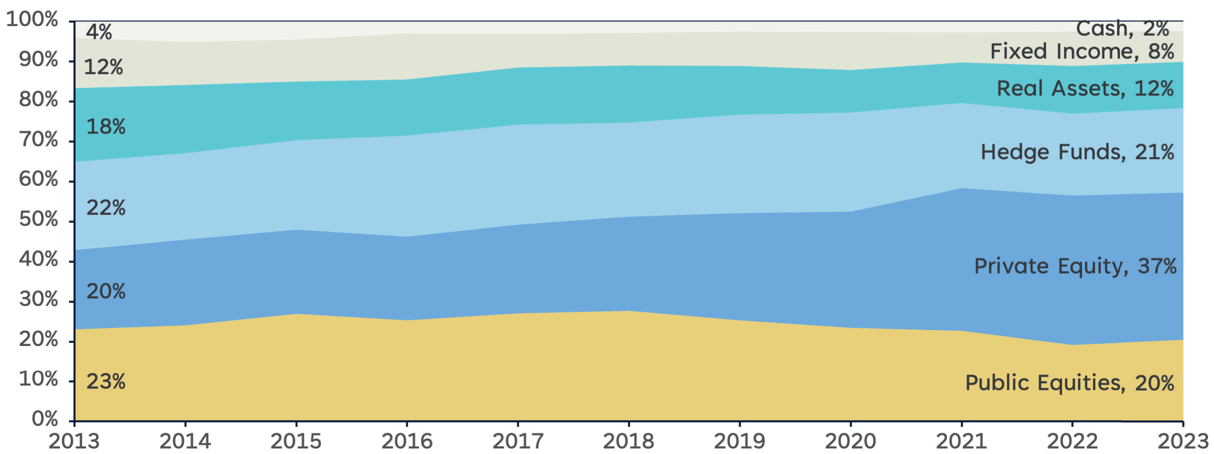


Source: True North Institute analysis of publicly available data

There is a continued clear trend among most large institutional investors growing allocations to private equity.

The sample of top 12 US university endowments shows private equity (incl VC) growing from 20% in 2013 to 37% in FY 2023.

Asset Allocation %



Source: True North Institute analysis of publicly available data

NACUBO shows that VC has grown from 25% of all private equity 10 years ago to 40% today for endowments >$1B in AUM. KKR's late 2022 survey of 30 large US endowments highlighted more interest today in **private debt** (from 3 to 4%) and **infrastructure** (from 5 to 6%), while seeing modest decreases in allocations to hedge funds. A May 2024 Preqin survey of 4,255 institutions confirmed these asset allocation shifts are carrying on today.

We have long viewed **infrastructure** investing as a poor use of "illiquidity budget." That is, we would rather see the full allocation to private markets to be heavily biased to the higher returning asset classes including venture (13.5% expected return), buyouts (11.5%) and opportunistic real estate (10.5%). We suspect that most investment committees may be revisiting this view, just as we are, given the specific higher returning investment opportunities that Blackrock and General Atlantic see on the back of their acquisitions noted above (i.e., the riskier end of energy transition infrastructure, data centres, etc.). While historically (2002 - 2018 vintages) infrastructure's returns averaged 5% below the average buyout return (10% vs 15% pa per Pitchbook), in future can see infrastructure with embedded commercial scaling and development risk offering similar risk-adjusted returns to buyouts.

Many large endowments with large allocations to **private equity and venture capital have seen their realised allocations outstrip their target allocations due to recent growth.** New commitments have slowed, but not enough to address the over-weights. We expect the recent public equities growth is outstripping private equity and VC marks, which will further reduce the over-weights. Given the high level of satisfaction with recent returns, we expect most investors will simply live with the over-weights and do little to reduce them.

We do hear debates about cutting **overall allocations to venture and growth equities** (public and private), but we see little action to sell secondaries or to reduce venture as a proportion of PE given the burgeoning tech opportunity set, with AI being the biggest order.

Since continued allocations to PE and VC may be is a key debating point for many investors,, we include recent and long-term global PE and VC performance below by strategy.

Over the long term, VC and buyouts, on average generate very similar returns, despite VC being much higher risk than buyouts.

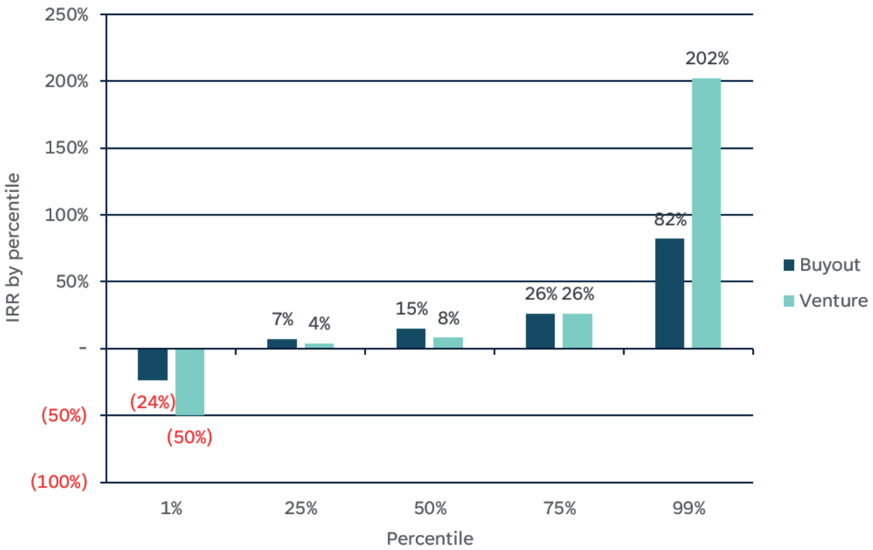
Strategy	Sub-Strategy	1 Year	3 Year	5 Year	10 Year	15 Year
Buyout		**9.1**	**13.5**	**14.7**	**12.9**	**14.1**
	Small Buyout	10.9	17.4	16.7	14.5	13.6
	Mid-Sized Buyout	8.8	16.7	17.7	15.6	14.6
	Large Buyout	8.0	12.0	13.6	11.7	13.2
	Mega Buyout	10.8	12.6	14.3	13.1	15.1
Venture Capital		**-1.2**	**4.5**	**16.6**	**14.9**	**13.9**
	Early Stage	-2.3	6.5	20.2	16.3	15.4
	Balanced	-3.1	3.7	12.0	12.1	10.6
	Late Stage	1.5	3.1	16.3	15.1	14.9
Growth Equity		**4.7**	**9.5**	**16.9**	**15.4**	**15.8**

Source: State Street as of 31 December 2023

Notes:
Growth Equity (or Expansion Capital) resides at the intersection of venture capital and control buyouts, usually a minority investment in relatively small/mid size, but mature companies.

3-year venture returns highlights that what can go up a lot (2021 VC returns) often comes down a lot (2022 and 2023 VC returns), leaving buyouts well ahead of VC over the last three years.

The top quartile of VCs has matched buyout performance over a 30-year period (1990-2019), but the top 1% have performed over 2x as well as the top 1% of buyout firms.



Source: Preqin, Cambridge Associates, KKR Global Macro and Asset Allocation Analysis. Data as of 30 June 2022

Short term worries about private equity. Goldman Sachs statistics show that 2018-vintage PE funds are 60% behind historic levels of DPI (ratio of distributed to paid-in capital), while 2020-vintage funds are 80% behind. That situation has led PE GPs to borrow money to distribute capital to LPs via structured dividend recapitalisations at the individual company investment level or borrowing at the fund level using so-called NAV loans.

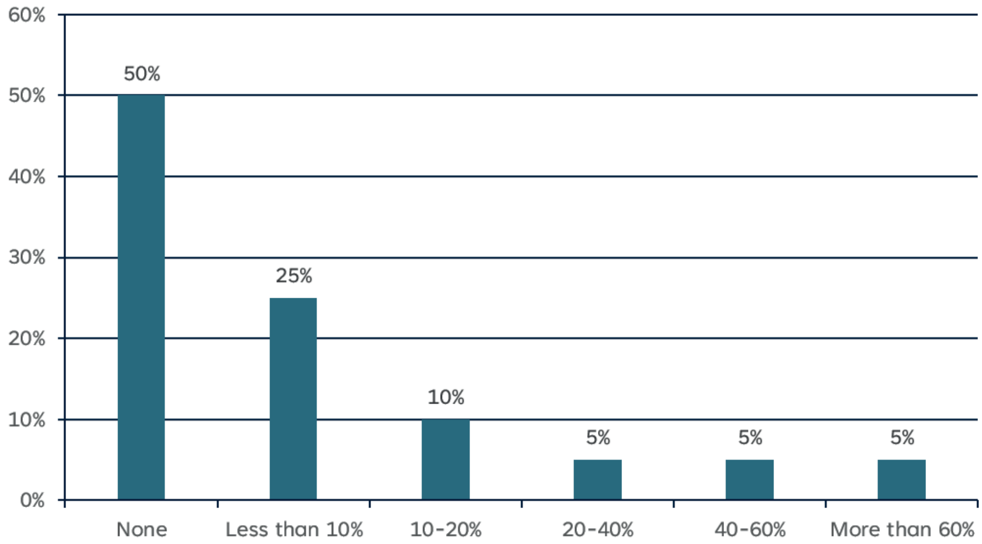
Are Bonds Back?

No, not yet… and probably not for a while. Allocations to fixed income have never been lower in institutional portfolios around the world than they have been recently. But with an inverted yield curve, US$ cash rates are at 5.3% today vs. 4.2% for 10-year bonds. Hence, there is no reward for taking duration risk and any bond allocations should go into 3-month Treasuries. So long bonds are not quite back yet. Most institutional investors we work with are asking us for a guide on when to allocate to 10-year and longer duration government bonds to take their proper place in a well-diversified portfolio. Interestingly, overnight forward rates are only expected to fall below 10-year forwards implied yield at the end of 2025 and only have about a 70bps spread five years from now. If the forward markets are correct, we probably do not need to contemplate bond allocations anytime soon.

Sustainable Investing Corner

Most institutional investor surveys continue to site ESG investing as one of the most important investment trends or themes including Mercer's November 2023 survey of 115 endowments and foundations (E&Fs). But 62% of those surveyed by Mercer do not have allocations to impact strategies, presumably including energy transition investments. KKR's endowment survey from September 2022, similarly, highlighted that, while 70% of large endowments are intending on investing in ESG related projects, very few have actually made any inroads into allocating capital. Concerns around return implications, a lack of robust data and the risk profile of investible assets are the barriers most cited.

KKR 2022 E&F Survey: What % of your assets are committed to ESG-focused strategies or managers that integrate ESG factors into their investment process?



Source: KKR Global Macro & Asset Allocation analysis. Date as of 31 August 2022

We see many investors finding their historical ESG policies to be too wide ranging and vague, migrating their ESG focus to some combination of energy transition investing and diversity, inclusion and equity assessments of asset managers in the portfolio. Institutional investors are only starting to engage with managers around how they value companies to include the likely future cost of carbon abatement, which will affect energy, utilities, industrials and transportation industries most.

Only 15% of the 115 E&Fs surveyed have set a science-based net-zero target across their portfolio. TNI's view is that net-zero targets for portfolios are misguided to the extent that they encourage disposal of the companies that are most critical to the energy transition. The largest decarbonisers and investors in the energy transition today are large electricity utilities, industrial companies and transportation companies, who are also among the largest emitters. Selling these companies to report a lower carbon footprint in the portfolio only serves to raise these important decarbonisers' cost of capital and discourage investment behind what would normally be profitable decarbonisation. Clearly, all investors should set targets for tonnes of actual carbon reduction from companies owned, not targets measuring the carbon footprint reduction from transferring to another investor.

CalPERs, the US's largest public pension fund, is the exception to what we are generally seeing, as they have recently announced an increase in investments in climate related opportunities, with $100B earmarked for investments in real estate, infrastructure and private equity by 2030. We would expect these investments to be primarily renewable infrastructure investments which have significant risk relative to the returns, given electricity grid permitting and interconnect backlogs. We believe that there are better ways for CalPERS to invest this allocation, as explained in our framework for investing in the energy transition, second edition, which is on our website. This framework points to making investments where capital can remove bottlenecks, such as investments in battery storage, distributed energy, EV charging, electricity efficiency improving software and services, etc.

Artificial Intelligence Corner

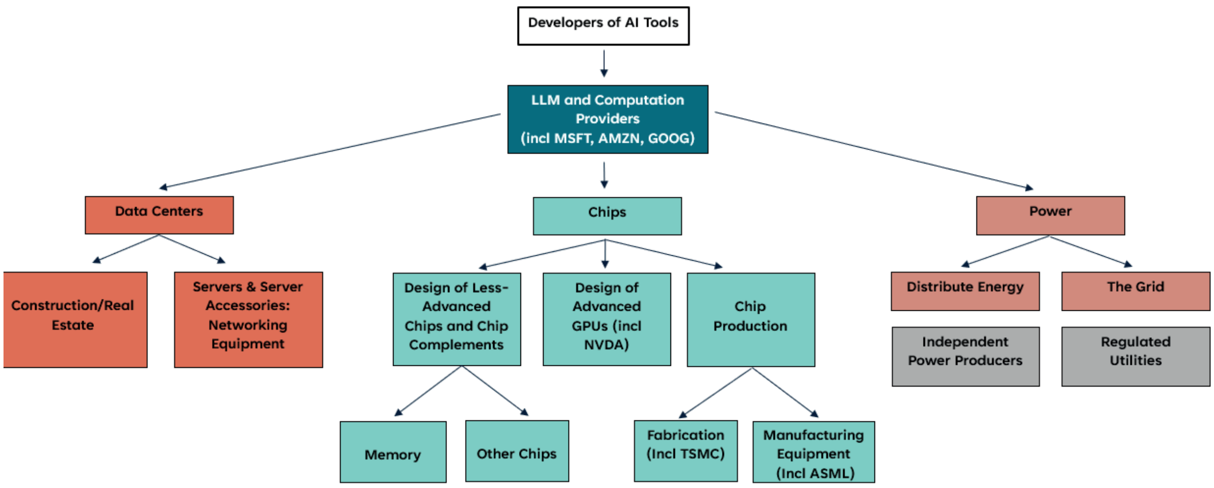
For any institutional investor, artificial intelligence has four relevant dimensions. We hope you will find this to be a helpful framework in your internal and investment committee discussions on the topic:

Level I: The impact of AI on the global economy, mostly in terms of investment, growth, productivity and inflation.

Level II: The impact AI can have on our overall portfolio management – this will mostly be about data mining and risk measurement and management.

Level III: Selecting the asset managers who will use AI to generate more alpha. LP teams need to understand how their managers' (GPs) alpha generation ability will be enhanced or hindered by AI. They need to understand how sectors and individual company's financial prospects will be transformed over time by AI. This is the most important aspect of AI in our current jobs as institutional investors. We have to learn from our managers and we have to be in a position to educate some.

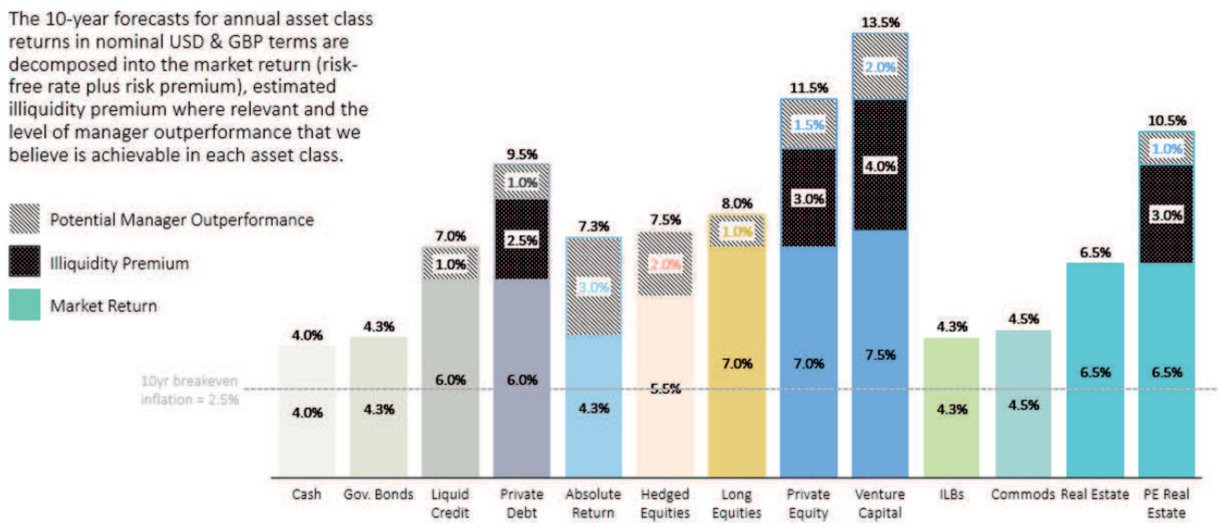
Level IV: Investing in "AI investment opportunities" including developers of AI tools, computation providers, chip manufacturers, data centres and power generation as shown in the chart below. These investments may involve specialist tech-focused public equity managers, VC firms with an AI vertical, and real estate companies focused on data centres.



Source: Adapted by TNI from Bridgewater, JP Morgan and others

In future editions of this newsletter, we will aim to include useful thoughts that we come across on each of the four levels to AI investing defined above, with our primary focus on how the asset managers' capabilities will be enhanced from AI. Greg Jensen, Co-CEO of the large hedge fund Bridgewater, recently wrote: "over the next decade, investors who most effectively harness the strengths of machine learning and navigate its weaknesses will likely build sizable economic moats."

Long-Term Return Forecasts



Source: Partners Capital Insights 2024

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