NORTH Dakota | State Investment Board
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Investment Committee
Tuesday, February 20, 2024, 2:30 p.m.
Virtual Only
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AGENDA

I. **CALL TO ORDER AND ACCEPTANCE OF AGENDA** – ***(Committee Action)***

II. **PRIVATE EQUITY INTERIM BENCHMARK (60 MINUTES)** – ***(Committee Action)*** – *Mr. Anderson*

III. **ADJOURNMENT**

Any individual requiring an auxiliary aid or service, please contact the Retirement and Investment Office (701) 328-9885 at least three (3) days prior to the scheduled meeting.

Memorandum

To: Members of the Investment Committee
North Dakota State Investment Board

From: Verus

Date: February 20, 2024

RE: Private Equity Benchmark and Benchmark Methodology Recommendation

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The purpose of this memorandum is to provide the North Dakota State Investment Board ("SIB") a Private Equity strategic and implementation benchmark recommendation and a Private Equity benchmarking methodology. For the methodology, Verus recommends a three-tiered approach to benchmarking Private Equity based on the life cycle of investment control (i.e., commitment gathering/investment decision making/distributing capital). The three-tiered approach is articulated below:

1. 'Start-up' mode = Benchmarked against itself (new strategies ≤ 3 years)
2. 'Post-start up' mode = Vintage year-weighted (strategies > 3 years)
3. 'Steady state' mode = No weighting by vintage year, use peer universe aggregate (≥ 10 years)

For the benchmark to be employed in Tiers 2 and 3, Verus is recommending adoption of the Hamilton Lane Private Equity Private Equity Index weighted by vintage year (for Tier 2) and the Hamilton Lane Private Equity Index, aggregate version (for Tier 3).

Recommendation Rationale

Benchmark: There are several reasons Verus' recommends adoption of this peer universe-based benchmark. First, we believe peer Private Equity universes provide the best means of measuring the strategic and implementation Private Equity decisions. From a strategic perspective, a Private Equity peer-based universe better meets the quality benchmark standards Verus presented to the Board at the November 17, 2023 Board meeting in that (1) it reflects the asset class investment opportunity set best, (2) is aligned with the Private Equity index proxy employed in the 2023 asset allocation study, (3) is transparent/measurable to RIO Staff through their subscription to the Hamilton Lane peer universe analytics system ("Cobalt"), (4) is reflective of the asset class return and risk characteristics, and (5) is used by similar investors. Verus undertook a Private Equity benchmark vendor study in late 2022 and viewed this benchmark vendor as favorable among the six firms evaluated. We evaluated the vendors in the following categories:

- Reporting mechanism
- Quality control
- Survivorship and selection biases
- Granularity of universes
- Avoidance of double counting funds
- Universe scope and scale
- Historical performance

Hamilton Lane was rated as follows in these categories:

Category	Hamilton Lane
Reporting mechanism	Below average
Quality control	Average
Survivorship and selection biases	Above average
Granularity of universes	Above average
Avoidance of double counting funds	Average
Universe scope and scale	Above average
Historical performance	Average to above average

Two important factors that are specific to the SIB and were considered in Verus' Private Equity recommendation are (1) the fact the RIO Staff maintain a subscription to the Hamilton Lane Private Equity peer universe analytics and (2) the majority of the SIB's Private Equity assets are invested in Private Equity fund of funds. The analytics subscription enables RIO Staff to slice and dice the universe as well as have look-through to the underlying funds so they can better understand the peer universe performance as well as create a custom sub-peer universe that better compares to the SIB's Private Equity program for internal monitoring purposes.

Having a current majority of the Private Equity assets in Private Equity fund of fund vehicles means the Private Equity program's performance will be impacted by the additional fees associated with those structures for many years to come even though all new Private Equity investments will be made in lower cost direct Private Equity investments. Only two of the six peer universe vendors Verus evaluated had peer universes for Private Equity fund of funds, Hamilton Lane being one of them.

From an implementation perspective, the recommended Private Equity peer universe-based benchmark is optimal in informing the SIB how successful the RIO Staff will be going forward in selecting those direct fund investments. This is particularly important given the benchmark will eventually factor into the incentive compensation metric for the asset class. A peer universe-based benchmark will be fairest in terms of evaluating RIO Staff's selection skill and will satisfy the Board that it is evaluating Staff's performance using an objective and appropriate benchmark. These factors, plus the results of Verus' Private Equity peer universe vendor comparison and the quality benchmark standards fulfilled by this benchmark support our recommendation to adopt the Hamilton Lane Private Equity peer universes.

Benchmarking Methodology: Benchmarking private markets investments is difficult for several reasons. With Private Equity, one of the complicating factors is the "J-curve" effect which occurs at the start of every new, or 'start-up' Private Equity strategy or fund implementation as fees are paid on commitments which do not bear fruit in terms of investment returns until after the first at least 2 to 3 years of the investment horizon. After this period, benchmarking versus peer funds can begin as the peer universes will be sufficiently populated with investment funds of commensurate vintage year, which is not typically the case for Private Equity peer universes for periods less than 3 years.

To address the unique benchmarking issues associated with Private Equity investing, Verus has created a 3-tier benchmarking approach. The objective of this approach is to maintain a single benchmark which evolves with the stages of a typical Private Equity investment program. We characterize these stages as modal states. ‘Start-up’ mode can be characterized as the initial roughly 3-year period of a Private Equity program, which will be meaningfully driven by the J-curve effect as well as the unique strategy being implemented by the Plan. Many GP funds don’t begin reporting results to peer universes until they have passed this J-curve phase or at least they are well into the beginning of the investment phase. Thus, peer universes will be sparsely populated during the first couple of years of a fund’s life, which normally should encompass between 12 and 15 years. This is why Verus recommends simply benchmarking the fund against itself for the first 3-years.

Once the fund is past the J-curve and well into the investment phase, characterized as ‘Post start-up’ mode, then it becomes easier to benchmark the fund versus the peer Private Equity universe on a vintage year weighted basis. The investment phase typically lasts up to 7 or 8 years, at which point, the fund enters into its final mode, ‘Steady state’ At this point, usually year 10, it is possible to switch to the broadest Private Equity peer universe, the aggregate peer universe which represents all Private Equity funds and vintage years, until the fund has completely wound down and returned all capital. We believe this recommended 3-tiered approach is fair to both RIO Staff and SIB as it is, again, objective in nature due to the prescriptive timing of benchmarking evolution from mode to mode as well as the defined benchmarks for each tier.