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What Ted's Thinking

The Impermanence of Permanent Capital

Back in 1994, I was overseeing Yale's boring, internally managed bond portfolio. We benchmarked the portfolio to the Lehman Brothers Government Bond Index and occasionally sought to add value buying securities with the same characteristics as a bond at a discount. [1] One example was the Morgan Stanley Government Income Trust ("GVT") a closed-end fund comprised of securities backed by the full faith and credit of the U.S. Government that traded around a 10% discount to net asset value ("NAV").

Closed-end funds are one type of permanent capital vehicle. The manager of the fund does not offer redemption rights to investors.[2] Instead, closed-end funds are publicly listed on an exchange, and investors get liquidity by trading shares. When we found a good manager trading at a discount at Yale, we supplemented our long-only portfolio with closed-end funds investing in domestic equities, international equities, and fixed income. GVT was my first professional involvement with a permanent capital vehicle.

Permanent capital vehicles are a dream for money managers. Whether markets go up or down or investors fall in or out of love with their strategy, the assets can't leave. Managers can play for the long term without worrying about interim liquidity needs that almost everyone else in the industry faces. Even ten-year private capital strategies end up buying assets with longer durations than the funds can hold.

From an allocator's perspective, permanent capital vehicles make intuitive sense, aligning the duration of their underlying investments with that of their spending needs. Universities educating scholars for centuries, foundations supporting humanity, sovereign wealth funds supporting citizens for generations, and pension funds doing the same for retirees have an incentive to optimize their return potential by matching the duration of their assets and liabilities. Continuation funds initiated from investors' desire to hold great assets rather than watch GPs flip companies from sponsor-to-sponsor, incurring frictional costs along the way.

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[1] Yes, it was a while ago. The index became the Barclays Index after Lehman's bankruptcy.

[2] This is a simplification. Closed-end funds may have tender offers and other mechanisms for shareholders to redeem at NAV. The prospectus for each one contains the liquidity rights. Not investment advice!

I currently invest in three permanent capital vehicles that offer different, attractive features.[3] Two are public vehicles with the permanent capital label, Bill Ackman's Pershing Square Holdings (PSH.LN) and Blue Owl Capital (OWL), and one is a private equity strategy, Brent Beshore's Permanent Equity. PSH offers Ackman's strategy with a little leverage and trades at a significant discount to NAV. OWL is a public asset manager that oversees $140 billion and collects fees on three permanent capital strategies. Permanent Equity is a twenty-five-year life private equity fund that pays out free cash flow annually and owns businesses with no intention to sell.

The problem with so-called permanent capital vehicles is that most aren't permanent at all. Closed-end funds tend to trade at discounts to NAV and are subject to pressure from shareholders to narrow or eliminate the discount. For example, Bill Ackman regularly buys back shares of PSH, each time increasing NAV per share but effectively redeeming a small sliver of AUM in the process. Brent Beshore's funds are effectively permanent capital, but neither he nor I know what will happen at the end of the quarter century term described in the fund documents.

Another challenge with permanent capital vehicles arises when people are involved, which is always. The media recently reported about strife inside Blue Owl. The leaders of two of its divisions, Owl Rock and Dyal, apparently aren't getting along and may part ways. I have not read Dyal's fund documents, but I imagine investors could have a key man provision that triggers a withdrawal right if its founder Michael Rees departs.

The potential for change within an investment organization poses an underwriting challenge for allocators considering a permanent capital strategy. In private equity and venture capital, GPs sign on to manage a fund for a decade even though the average length of a marriage in the U.S. is significantly shorter. Permanent capital vehicles take it even further in assuming individuals driving the investment strategy will be around their seat "until death do us part."

Let's not forget that allocators are people too. The organizations they represent may own assets with a perpetual life, but the individuals making investment decisions on behalf of the institutions are anything but eternal. Charles Skorina reports that only about a third of the top one hundred endowment CIOs have held their role for a decade or more, and the average tenure is under six years.[4] As Jeremy Grantham pointed out long ago, job risk is the biggest risk in institutional investing.

Despite the messiness of the concept, permanent capital, or at least longer duration capital than others, provides a competitive advantage that allows a manager to persist through market cycles and organizational challenges in an industry whose time horizons are shorter than everyone believes they should be. And whether a feature or a bug, permanent capital vehicles are one way for allocators to reduce behavioral bias in decision making.

If I recall correctly, GVT held $800 million in assets and its manager, Raj Gupta, ran a multi-billion-dollar open-end fund side-by-side. Through a series of persuasive private letters, David

[3] Not investment advice!

[4] Charles Skorina & Company, Endowment Performance Rankings 2020 – Strange Days, 5/1/21.

Swensen convinced the Board of the closed-end fund to merge the vehicle into the open-end fund and eliminate the discount.

In the blink of an eye, the permanent capital vehicle was gone.