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EPISODE 67:

Mapping the Future of Alternative Investments

with Caprock

Robert Morier: Welcome to the Dakota Live Podcast. I'm your host, Robert Morier. The goal of this podcast is to help you better know the people behind investment decisions. We introduce you to chief investment officers, manager research professionals, and other important players in the industry, who will help you sell in between the lines and better understand the investment sales ecosystem. If you're not familiar with Dakota and their Dakota Live content, please check out dakota.com to learn more about our services. Before we get started, I need to read a brief disclosure. This content is provided for informational purposes and should not be relied upon as recommendations or advice about investing in securities. All investments involve risk and may lose money. Dakota does not guarantee the accuracy of any of the information provided by the speaker, who is not affiliated with Dakota. Not a solicitation, testimonial, or an endorsement by Dakota or its affiliates. Nothing herein is intended to indicate approval, support, or recommendation of the investment advisor or its supervised persons by Dakota. Today's episode is brought to you by Dakota Marketplace. Are you tired of constantly jumping between multiple databases and channels to find the right investment opportunities? Introducing Dakota Marketplace, the comprehensive, institutional, and intermediary database built by fundraisers for fundraisers. With Dakota Marketplace, you'll have access to all channels and asset classes in one place, saving you time and streamlining your fundraising process. Say goodbye to the frustration of searching through multiple databases and say hello to a seamless and efficient fundraising experience. Sign up now and see the difference Dakota Marketplace can make for you. Visit dakotamarketplace.com today. Well, I am thrilled to introduce our audience to Chris Schelling, Managing Director of Private Markets for Caprock. Chris, welcome to Philadelphia.

Christopher Schelling: Thanks for having me, Rob.

Robert Morier: Yeah. Thanks for being here, and as always, Andrew O'Shea, welcome to the desk again.

Andrew O'Shea: Thank you. Excited to be here.

Robert Morier: Yeah. It's exciting to have you here as well. So, thanks for being here. Well, we have a lot of questions to ask you, Chris. Before we do, I'm going to read your background for the audience. Chris Schelling is an investor, advisor, and published author. During his more than 20-year tenure in the investment industry building portfolios, mostly focused on alternatives, Chris has met with over 4000 managers and allocated roughly $7 billion, generating top quartile to top decile returns across hedge funds, real assets, private credit, and private equity. Chris is currently the Managing Director of Private Markets with Caprock. Caprock is a multifaceted, wealth advisory firm that specializes in providing comprehensive investment and wealth management solutions to high-net-worth individuals, families, and institutional investors. Serving over 300 families, Caprock

advises on now over $10 billion in assets, after a recent acquisition of Grey Street, based out of Chicago, of which that $4.1 billion is allocated to private markets and $2.2 billion is deployed with impact intentionality. The firm is an SEC-registered investment advisor and a founding B corporation, headquartered in Boise, Idaho, with additional locations in Seattle, San Jose, Newport Beach, Park City, New York, and Austin, where Chris and his family are based. Chris has been active in manager research and asset allocation for two decades, from Mercer Investment Consulting, as a senior investment associate and hedge fund manager research, to the Kentucky Retirement System, as deputy CIO and Director of Absolute and Real Return Strategies. For over five years, Chris was the Director of Private Equity with the Texas Municipal Retirement System and, more recently, the Chief Investment Strategist with Venturi Private Wealth. Chris earned a BS degree in Psychology and an MBA from the University of Illinois. Chris also earned an MS in Financial Markets, from the Illinois Institute of Technology. Chris is also a Global Investor Advisory Board member for the alternative investment management Association, an Investment Committee member for the Catholic diocese of the Diocese of Austin and 1,200 VC, respectively, and finally CAIA Association Austin Chapter executive. Chris calls the Austin area home, where he enjoys the outdoors, fitness, spending time with his family and two dogs, writing, reading… we're going to talk about your writing… and movies. Chris, thank you for being here. Congratulations on all your success.

Christopher Schelling: Well, thank you, Rob. I appreciate that.

Robert Morier: I usually start with the beginning, but I'm going to start with now. Where do you find all the time?

Christopher Schelling: Yeah. That's a mouthful. There's a lot of words in there. I don't have a magic bullet answer for that, honestly. It's just going where I feel there's value that I can create. So, a lot of it is reading, researching, writing stuff that's applicable for our clients. Yeah, but it keeps me busy. That's for sure.

Robert Morier: It sounds like it. Well, we will go a little bit back to the beginning. We have a lot of students and educators who are now tuning into the show, because frankly speaking, manager research and due diligence aren't widely taught at most universities. So, one of the questions I often get from those listeners is how did you find your way into manager research and due diligence? So where did your journey begin?

Christopher Schelling: So, I'll give you the short version. My undergrad is in Psychology. I knew that I loved thinking about how people think and learning how they make decisions. Didn't really envision a career in the field of finance until I got my MBA. Where I had a great professor, J.B. Kirsch, who's now a dean at Emory, and he was dynamic. He really made it obvious that investments was this combination of math, which I had an aptitude for, and behavior. It's the behavior of market participants, and it's statistical. So, I got a

job after the MBA in an asset management firm and wanted to get closer to the assets. And so, the journey was really wanting to learn more about how to manage money and get closer to owning the assets, as opposed to being an intermediary. But I also had this interest in alternative investments as being the cutting edge of the asset management industry, this like creative destruction of capitalism that is occurring… managers coming in, managers blowing up, new strategies evolving, and capital pursuing that. And so that just led to this evolution of getting closer to those strategies, learning more about them, and wanting to understand how they work.

Robert Morier: I'm curious. At the time that you were studying, was there anything specific around alternatives that was being taught, or is there anything over time that you realized needed to be developed, as it related to your own education?

Christopher Schelling: Yeah. There really wasn't any like collegiate curriculum around alternatives as a course of study, or at least not to my knowledge. The Chartered Alternative Investment Analyst Association was just being built, and so I got that designation early on, 2008, I want to say, maybe 2007. But fast forward again a few years, I designed and taught a class at the University of Kentucky on just that. It was an elective course on alternative investments, because I thought it was something that I had knowledge of as a practitioner that was lacking in the field, from an applied perspective.

Robert Morier: Well, you've worked on various sides of private markets, over the years… venture capital, private equity, private credit. So, what's equally interesting about that is you've been doing it with public pensions, as well as wealth management. So how do these different aspects of private investments intersect, and what unique insights have you gained from each of these, as it relates to that crossroads?

Christopher Schelling: Trying to put the whole puzzle piece… all the puzzle pieces together has been part of the journey. So, I'd say there's been an evolution from hedge funds to more private markets, in terms of my career. My first job was at an asset management firm that had long-only convertible strategies and convert art. So, they had hedge funds and registered products. I was at Mercer on the hedge fund side. At Kentucky, I ran both hedge funds and real return. So, I had seen what was occurring in hedge funds was this dimunition of the returns. Alpha was basically disappearing. There had been a ton of capital coming into the space. First, it was kind of ENF, and then it was the larger pensions, which had bigger checks to cut. And I think it was 2006, where JP Morgan's prime brokerage team actually released a great research report about, have hedge funds eroded their own opportunities? And that is clearly what had happened. You could just plot like 15-year returns up into that point, 15-year returns after that point, and they'd all been cut almost in half. And so, sitting in a seat at a big pension, putting money to work, and hearing a lot of the grumbling from boards… from executive directors, from constituents that were paying fees for stuff that were not getting risk-adjusted returns in

return for. Didn't want to be stuck in that vertical, going forward, because I was pretty convinced that returns would be muted or disappointing. And so, building the real asset portfolio was when I got to dive deeper into private markets. And what I… what I experienced was that there's just more inefficiency and more of an information advantage. I still think that persists today. It has changed, and it's become more efficient. But you basically don't have data ubiquity in private markets, which means you can have an information advantage. You can have a processing advantage. On the public pension, the individual investor transition, I don't want to say pensions have reached full allocation, but they're nearly there. 30%, 35% to private markets, that's the typical allocation for most public pensions today. ENF is even higher than that… 40%, 50%, depending upon how big your foundation might be. And so, the next big trend for alternatives is going to be… and it is. It's happening right now… is individual investors accessing that space in scale, and the scale is trillions of dollars.

Robert Morier: We're going to talk more about that democratization of alternatives for the individual investor. Before we do, as of the end of the year, over half of the assets at Caprock were in alternative investments.

Christopher Schelling: Correct.

Robert Morier: So, you have spent a significant amount of time building that portfolio prior to you joining and, obviously, in your role today. But for our audience, who may be less familiar with Caprock, your role on the team and what your team looks like, would you mind giving us a little bit of context?

Christopher Schelling: Sure. Yeah. That was part of the reason, or a big part of the reason for joining Caprock, was the belief in private markets as a driver of value creation for our clients and constituents. It's preaching to the choir, as opposed to trying to convert non-believers. So yeah, $4 billion plus in committed capital, private markets, since the inception of the firm. 18, 19-year history, and almost all of that has included allocations to private markets. To date, our team, on the private market side, I would say, call it six people, full time. We're a distributed workforce, which presents its own challenges. But I think, today, with things like this, it becomes pretty easy to actually interact with people in all of our different offices, and that gives us a nice footprint to meet managers on the road in different spaces. So, we have pretty standard processes, we have multiple weekly calls. We have pipeline conversations. Things progress through the funnel. Ultimately, full IC memo and approval, and they make it into our client portfolios.

Robert Morier: Is manager research centralized? Are you all based in Austin, or how does it work—

Christopher Schelling: No. We are distributed. So, we have team members in San Jose. On the investment side, obviously, in all of our cities, we have client-facing people, but we have investment people in San Jose, Boise, Seattle, which is Mercer Island. We have people in New York and then people in Austin as well.

Robert Morier: So, taking all of those people into the process, how does that top-down process start, in terms of asset allocation, thinking about… obviously, you have individual clients. So, there will be bespoke needs. But if you think about some of the direction that's set, as it relates to the compass of the team, how does that process work?

Christopher Schelling: Yeah. So, there's multiple things that go into it. It's not, I wouldn't say, a top-down thing, per se. That 30%, 40% allocation to private markets, that is in aggregate at the firm level. We have clients that can have none to almost 100%, depending upon their specific needs. And the advisors really help drive that asset allocation. Now, we have an investment team. We have a chief investment officer that has views on capital markets and somewhat tactical beliefs about returns, but I don't think it's a top-down push towards our advisors. Our advisors are investment professionals. And I've been spending a lot of time trying to proselytize more of the institutional approach, I'll say, where we're doing sort of a pacing, where we're looking across our client portfolios. We're aggregating need for capital and saying, how much money should be deployed into private markets over the next year or two-year period? Because they might have prior assets that are going to be rolling off. They might have capital that's coming in from exiting a privately held business that they own, for instance. And then we take that capital, and we deploy it. So that does kind of become top down, in the sense that we might know 200 million, in aggregate, is the number that we need to fund. And then the team is out there sourcing managers in real time, to put that capital to work, across our best ideas.

Robert Morier: I'm sure you know you're not alone on that soapbox.

Christopher Schelling: Correct.

Robert Morier: There a lot of wealth managers that are doing the same thing.

Christopher Schelling: Correct.

Andrew O'Shea: I would be interested. Just operationally, you're coming from a pension where you're investing out of one big pool of assets. Obviously, with families, that's a lot of different pools of assets. How are end clients accessing the strategies? Have you created pool vehicles to access private investments or are they large enough that they're just allocating individually?

Christopher Schelling: It's a bit of both. I'd say that's the big difference between the individual side and the public or the institutional side is that we have about 300 different families that we work with, and they're kind of bifurcated. You can think the 80/20 rule. A big chunk of the assets are with some of the larger families, and then we have, of course, some smaller families. And so, the way you can service those two sets of clients is different. We do have fund-to-funds. I mean, we call them co-mingled vehicles or think of them as a managed account solution. And so, we're on our fifth vintage. We'll be coming to market with that here shortly, and we target probably 100 to 150 million. Could be larger than that, given our recent acquisition. And that's a way for clients, really, of all size to access that core portfolio. And so, think of that as, maybe, 10 to 15 funds. We'll have maybe 10 co-investments underneath that. And clients can get a full allocation. If you're of such a size where that really is the entirety of your private markets portfolio, then that's what you do. When we find a manager that has capacity for the fund and additional client capacity, we will take that out to our bigger clients. And so, we just closed on a fund a month ago where we had, I think, 20 checks in it, so one from our fund-to-fund, and then our additional clients can upsize. So, it's a little bit of a hybrid approach because of our client base.

Andrew O'Shea: And the fund-to-funds would be designed to be your all-encompassing private solutions?

Christopher Schelling: Well, we have multiple different sleeves there as well. So, we have an impact-focused fund-to-fund. We have a real estate, real asset-focused fund-to-fund. And then we have the private equity VC one, which is a higher cost of capital. We have not done a credit vehicle because we can access that through evergreen and drawdown structures directly on client balance sheet, but that's something that we could consider, too, at a later date.

Andrew O'Shea: Take us through your typical manager underwriting process. You've identified you have 200 million that's rolling off, getting put to work. You've identified a few asset classes and dwindled it down to handful of managers. Take us through that process in general.

Christopher Schelling: It's just iterative, honestly. So, we have, like I said, six people. All of us will be sourcing. Sourcing is a three-legged stool. We'll just get inbound, and there's a lot of inbound. I mean, I'd probably call it 25 to 50 unsolicited a day. Vast majority of those maybe don't get a lot of time because they're, maybe, not as good a quality as some of our targeted outbound. And then there's the reference network, where we'll have an LP tell us, oh, you should look at this or a client tell us, you should look at this. And so those are really the three. We have a quick review, where the front-line person is looking at the material, maybe taking a quick call. And then we have what we call a prioritization process, where we have a framework to actually score something that we think should be

sent to the broader team to say, hey, let's get some temperature on this. What do you think? Is this worth additional work? Should it pass that process? Then the lead investment professional will schedule an additional call, maybe get access to the data room, and just keep working through it. So, I mean, from cradle to the grave, it can take anywhere from six weeks to maybe six months.

Andrew O'Shea: Are there any must-haves you have, whether it's fund size, years of experience working together? Are there just hurdles you have to get through before you'll even dive deeper?

Christopher Schelling: I'd say that one of the benefits of being on the private side is there's not hard and fast rules. On an institutional side, you may have a required minimum fund size. You may have a minimum three-year track record. In principle, we want to see a team that has worked together. We want to see some evidence of a proven track record. We want to see the required scale for you to execute on that strategy. And that can be very different. An early-stage VC or a seed fund, that's going to be a smaller fund. But for a large, opportunistic credit fund, it could be a little bit bigger. So, we want you to have the right capital base to execute on your strategy. We've done plenty of fund ones in our history, too.

Andrew O'Shea: That's interesting. In the bio, Robert touched on investing with impact, intentionality. Could you expand on that portfolio?

Christopher Schelling: Yeah, so this is not my area of expertise. We have a managing director who is, I think, he is the guy, Mark Berryman, in impact. However, what I will say is, what we do is we provide the tools for our clients to invest their personal portfolios, according to their values. And so, we have clients on both ends of the spectrum… I mean, literally as far as you can possibly get. And we're underwriting managers and co-investments that can help them invest according to those values. I'll say we do a great job of reporting and putting metrics around that impact so they can understand whether or not it's working as well. We have proprietary tools in that space. But it's not a top-down lens where we think, this is how you should do it. It's more, here's our menu. What do you believe? How can we help you invest like that?

Robert Morier: Chris, you've been doing this a long time. So, I suspect when you came to Caprock, you had a roster of managers that you've known, maybe have carried with you from firm to firm. What are some of the common traits that you've found when you're looking at managers, when you think about the must-haves or the characteristics that are consistent among those managers?

Christopher Schelling: One of the biggest factors, to me, is the motivation of the investment team. I have a friend who once referred to, you want to make sure that

they're not calling in rich. They don't get to the point where they're not incented to generate returns anymore, you can see this in all sorts of different ways, but I think that that's the clear signal that you shouldn't continue to work with them. I've used tools in the past, like psych profiles… we've chatted about this… where you can measure their motivation. I want a team that still has a little bit of hunger, wants to generate stronger returns, and they have their personal net worth invested in the fund. But I also don't want to take true fund one risk. So, where it's a team coming together for the first time and haven't got any evidence that they've actually done this. Maybe they're spinning out from a bank, and the value add could have been the flow of the seat as opposed to the team itself. So, you want to make sure that that risk is diffused. I call it fund-one upside with fund-three risk. Maybe it is fund two. Maybe it is fund three. Or maybe it's a team turnover situation, where it's a fund four, and you can see the team that's actually had attribution for the strong deals has now assumed more of a mantle of leadership within the firm. So that's the consistent theme. It's still small enough to be nimble, still young enough to be hungry, but experienced enough and there's enough demonstrated success that your risk is a lot lower.

Robert Morier: How do you draw the line between punishing a manager for success? For example, I worked for a manager once who started buying racehorses. It didn't look good optically, but he was still generating alpha.

Christopher Schelling: There is no clear bright line, I have to say. And a lot of it is just experiential, and it's judgment. And you're going to get it wrong. I mean, you're going to re-up with a manager, and you're going to go, well, that was the time to get off the bus. I missed that one. But it's more just, I think, important to have that humility that, hey, you've got to re-underwrite fund over fund over fund and not just be comfortable with, yeah, we have a great relationship with this team, per se. So, there's certainly ones where I wish I would have stuck with the team longer as well, just realized that that's how it works, that motivations change. It's your job to go in and see, does an incremental dollar from my clients and constituents still make sense to be put to work with these managers? And I mean, that's really what being a fiduciary is, is not just do it because it's easy but, is this the best use of this incremental illiquidity for my client?

Robert Morier: You've written a lot about being a fiduciary. Specifically, you wrote a book called Better than Alpha, which I highly recommend. For our audience who are listening in, we'll put the link to look at the book if you're interested. You write about what you call organizational alpha or smart governance. So, you've said believe the best teams across, really, any domain, do that. So how do they're the right team? So, you've talked about some of the characteristics. But the team needs to come together. It's typically a collective that's making these investment decisions. So what criteria are you looking for as it relates to the team who's making the decisions?

Christopher Schelling: Some of it gets back to that humility, to just know when you're wrong. I've worked in teams before where… and a lot of it has to do with the trust of having worked together. Sometimes, it takes years to engender this type of teamwork, but where someone can tell you you're wrong, and you don't get defensive to that. So, I worked with an individual at Kentucky Retirement System and Texas Municipal Retirement System that has been, probably, the best person in my career to point out mistakes, whether it's a math problem or just a thesis that you got wrong or no, the market is actually this, not that. And if you can get to that point where everyone on the team can point out each other's mistakes and it's not taken defensively, then you know that you're able to really incorporate the best ideas from the rest of the team. But also, again, back to motivation, this is a people industry. People do two things, by and large, in their career, I mean, maybe in general but in their career, definitely. They do what they get paid to do, and they do what they love to do. If you can sync those two things up in your role, you're going to have success. But you can't take people and just make them do a job because you need them to do that. Some of the biggest problems I've experienced are, where, well, we need you to do this. It would be like, if you were my basketball coach, Rob, and you said, well, just do a 360 Tomahawk dunk and go win the slam dunk contest. I've created the perfect plan. You just need to execute on it. I'm not capable of that. I got to raise my hand and say, I can't, but you also have to listen and say, we've got to find someone else for that role. The same is true in investing. It's not all one job. There's lots of different roles. And when people are struggling in a role, it's your job as a manager to be like, this is not the right role for them. And that's a big part of managing that team.

Robert Morier: Well, rest assured, I was an undersized forward, so I was not doing anything exciting on the basketball court. Does that tie into what you had written about, intrinsic and extrinsic motivations in determining the investment outcomes? So now, you've got the team, the want and the love, the intrinsic, the extrinsic. What advice do you give to investment firms aiming to optimize their team's investment performance?

Christopher Schelling: Well, I mean, you can use personality profiles to actually see what people are good at and what they really want to do. Part of implementing that for our manager due diligence process… and not to get derailed on the subject here, but I think it's probably helpful for your audience to understand… we implemented this at Texas Municipal, found a psych profile, 45-minute online test, measures a bunch of different stuff. We gave it to 150 GPs. And what we found was that the best GPs were doing something similar, either for their portfolio company execs or for their in-house teams because they wanted that same insight. How do we make decisions collectively, and how do I optimize my team performance? How do I build that smart governance, that institutional alpha, organizational alpha internally? And so, I would say, you can use tools to do that. Part of why we picked this tool was our team at Texas Municipal gave it to ourselves and looked at the results and said, yep, that's me, warts and all. So, two great examples are… I use this for a lower-middle market industrial firm, and this is a firm that I

have re-upped with. There's a section in there called Areas of Interest. And it would be similar to the aptitude test we took in high school, like Sally's good at science or Joe should go into art or whatever. And it had all kinds of different fields. And this particular manager scored highest on mechanical. And what he was doing was industrial firms. And he had literally said on our on-site visit, I'm an engineer by trade. I love going in and seeing the plant floor and rolling up my sleeves. And so, when I got that validation, I'm like, all right, he actually really loves what he's doing. I have more confidence that his performance will continue because work isn't a slog for him. He loves it.

Robert Morier: I'm just curious. Is character part of that assessment? Meaning, are they going to do the right thing?

Christopher Schelling: Yeah.

Robert Morier: We talk about governance and things around responsibility, ethics, virtue investing, however you want to describe it. I'm just curious if that assessment captures why people do what they do and in the context of who they are.

Christopher Schelling: So, when we looked at the tests, there were components, modular, that you could put into it. And so, this was an aptitude, a psych profile. They also had what they had referred to as the psychopath test. And we thought from a partnership perspective, probably not the best way to begin a partnership, by asking them to take a psychopath test. But that was measuring for things like the dark triad, machiavellianism, narcissism, psychopathy, hopefully subclinical. And we elected not to do that, but there were components of the test that could measure whether or not were lying, whether or not were being truthful in your responses. And so, we had that element of it. And, actually, we did have one GP fail that. And the test scored his responses as not truthful. I'll say, again, anecdotally, that was a person that you always felt a little iffy. You felt like were being sold all the time and didn't completely believe them. I will say, I don't think the psych profile gives you insights that you can't get through other methods in due diligence. You can see honesty and integrity in a lot of different ways. Just a simple one is to ask the same question over the span of years. So, here's where the institutional track record knowledge helps. You meet a manager, and they say, we're going to do x. And then, two years later, they do completely something different. That's some knowledge that you can aggregate over time. And I think it speaks to, do they do what they say they're going to do?

Robert Morier: I love this tangent. I'm just curious, thinking about that assessment, did you consider bringing in a 360? So, would you ask the GPs if you could go out, talk to their LPs, talk to their colleagues, talk to their vendors? Was there any consideration in going outside of the self-assessment, into a 360 assessment?

Christopher Schelling: Not using the psych profile, but I will say, those references are also an important part of the process. And so, we would include off-sheet references for every GP that we invested in. Most of the time, when you're looking at a fund one or a fund two, you need to verify that prior track record because it's not an audited track record with their firm. And so, in so doing, you have to talk to the portfolio company executives at those companies and say, again, did you work with Joe and Sally or not? And they can tell you a lot of how that team works in the real world and how they treat people. You can talk to LPs. You can talk to prior employees. I think that's probably one of the best ways. Try to triangulate, through your network, an employee that used to work with them at a prior firm or worked with them and have since left. You can get good references. You can get bad references, but you often get a pretty unfiltered view of how that person works.

Robert Morier: I'm going to give my toddler the psychopath test because I have a lot of questions about her behavior recently. That's really interesting. Thank you for allowing us to go on that tangent with you. Well, your writing is prolific. And frankly, I've been following it now for a while. You have a relatively new feature that you have on your LinkedIn profile called Alternatively Speaking. And you talk about the x ratio and the I ratio as tools for assessing investment managers. So, for asset managers who are listening in, could you elaborate on how you think about those two ratios, what they are, how they're applied?

Christopher Schelling: Sure, yeah. Those are both back to motivation. So, if you look at… from, again, the behavioral psych degree, there's two theories of motivation. There's an intrinsic theory, extrinsic theory. Extrinsic theory are external rewards, whether it's money, it's praise, it's all sorts of things. Intrinsic is the joy of doing the job. And there's lots of different ways you can look at it. We chatted, I think about, Daniel Pink's book. And so those are all tied together. I wanted ways to measure those. One of the things that the psych profile was intended to do was to debias my own biases. Any time you meet someone in person, you wind up liking them more than you did prior to the meeting… I mean, most of the time. I mean, maybe one out of 10, you're like, well, they're idiots. But most meetings follow a pretty well-worn script, and you walk out of there going, oh, they're smart. They're nice or I think they're good at this. Well, how can you quantify that without just relying on your feelings? So that's where the test came in. But I found that I could measure some of those intrinsic characteristics using that aptitude portion. And so, we started to aggregate these numbers across team members at GPs. And we found an interesting correlation between what the teams like to do and the strategies of how they invested. And so, for instance, VCs, venture firms, scored much higher on creative interests, I mean, much, much higher, whereas buyout firms scored much higher on financial and administrative. And if you look how they create value at their portfolio companies, it makes sense. Buyout firms create more value from optimizing balance sheet, getting smart leverage, multiple arbitrage, whereas venture firms are not just growing revenue. They're creating a product. They might even be creating a whole

market. They're creating a business. And again, I believe that people have a tendency to do what they love to do. And if I can actually measure your self-reported interest in such a way that I can tie that to what you do on a day-to-day basis, I have more confidence that your returns are going to… in technical terms, conditioned upon your high intrinsic motivation score, I have more confidence in persistence of returns of that firm. On the extrinsic side, you want to see that they're aligned with making money the way you want to make money. Rather than raising assets and selling, you want them to generate the return profile that you want them to generate. And so, we look through their historical track record, fees from other versus fees from performance, like carry and incentive fees. And we want a specific ratio that we think is incenting them to go behave the way we want them to behave.

Robert Morier: Interesting. Is part of that illiquidity? How does illiquidity fit into that assessment?

Christopher Schelling: Yeah, so I think illiquidity itself is not a source of returns. So, I've written about the illiquidity premium. I think that's a heuristic. That's an aggregate. What's happening is you're getting more of what drives returns in illiquid assets. So, you're getting more income. You're getting more growth. You're getting more value, et cetera. And the reason you're able to is because the markets are priced in efficiency. There's wider bid-ask spreads. You can maybe cross the spread, or it's not priced accurately, but you're buying things that are cheaper, you're buying things with higher yield, and then you can make more money for having locked your capital up. So, in order to ensure that we're getting enough of those returns, that's where we're doing the real rigorous underwriting and making sure the team is in line to generate those returns for our clients' illiquidity.

Robert Morier: Could you talk a little bit about the penalty-cost approach. So, it's been used by other institutional investors. It demands higher returns for increased commitments to illiquid investments. But could you provide more detail how this approach has worked in practice?

Christopher Schelling: Yeah. MIT has a great piece from a few years ago on how they describe how it works for them. It's conceptually pretty easy. The more and more illiquid your portfolio becomes, the more you should require a higher illiquidity premium… I'm speaking out of both sides of my mouth now… liquidity premium from your next dollar at work into an illiquid asset. And so, if you're 20% private equity, when you bring something, it needs to be really compelling for you to make an additional commitment to get to 21% or 22%. And so maybe you're required rate of return effectively has to go up for each dollar. And it's not the same for every investor. You can have an investor that's highly liquid, very long dated and should probably be putting more into illiquids versus someone that shouldn't be into liquids at all. I was at a pension plan that was

underfunded. Our rebalancing was each month, do we sell 80 million of stocks or do we sell 80 million of bonds? And so that's got no appetite for liquidity. So, it's different for each investor, but I think that conceptually, that's super important.

Robert Morier: Should they be available, then, for individual investors? You wrote an interesting piece called "The Dangerous Democratization of Alternatives" on the website recently. So, when you think about the potential… it's not even potential anymore. It's happening… for the democratization to change this investment landscape, how do you foresee those traditional barriers between retail and institutional investment strategies continuing to evolve? I know, Andrew, you also spent a lot of time with your clients, thinking about this shift that's going on in the market.

Christopher Schelling: The barriers are falling away right now. And I'd say the flip side of that inefficiency in private markets is, it's hard to understand. It's complexity. And you have broader dispersion of returns because of that inefficiency. So, the better are better, and the worse can be even worse. And so, it's important for individual investors moving into alternatives to avoid that worst part of the spectrum. And I'd say, historically, Wall Street has not necessarily done a great job of getting the best product into retail portfolios, but they've done a great job of getting product into retail portfolios. And so, some of the rappers that have been created might not be the best alignment. They might not have the greatest asset liability match, but there's others that do make sense for clients, that can put money to work in private markets. I mean, I believe… this is personally my belief… that private markets offer the best-risk adjusted returns because they are less competitive. And so, if you can put your capital away for 10 years, you should be investing in those asset classes. The flip side of that is, what retirement capital isn't put away for 10 years? I mean, that's the whole point. You're setting it aside for 10, 20, 30, 40 years down the road. I think the vast majority of clients should have some allocation there, but it needs to be done right.

Andrew O'Shea: I had one question. You talked earlier about hedge funds and then how a lot of capital flowed into hedge funds, and then the returns diminished. Is there any parallel that you foresee to that in private markets or is it that it's such an inefficient space that there's always going to be opportunity?

Christopher Schelling: There are not just parallels. It's the same thing. It's happening. But again, pensions are pretty close to allocation in private markets. Maybe some of them are at 14 and want to get to 15, but by and large, that big wave has been done. And I'd say, if you look to where it's happened, a big chunk of that capital has gone to big firms. So, what's happening is it's bifurcating, but because of the size of private markets relative to public markets, the public capital markets, it's able to absorb that. I mean, they're multiples of the size… there's 7 million private businesses in the United States that have at least one employee. There's 3,500 public companies. And if you even you look at it at

companies with 100 million in revenue or more, those are big companies. There's 200,000 private companies that size. And there's only 2,500 publicly traded companies that size. So, it's just a deeper market. It can absorb that capital. But to my point, what is happening is that there is a little bit of bifurcation. The big are getting bigger, and they're consolidating, and they're winning. And what's happening at the lower end of the market is that that hasn't changed much. In market, you have about 2,000 private equity firms, in any given year, raising capital. A thousand of them are pretty small. There's, I want to say, 500 that have less than $250 million on the cover of their fund, meaning they're raising a very small fund. That only raises 1% of the capital that's raised. So, if there have 500 million or billion or 800 billion that is deployed to funds each year, a tiny, tiny percentage of it is going to that segment of the market. And so that market's not changing much. It looks like private equity did 40 or 50 years ago. So, you have to understand that private markets aren't one monolithic thing. Where are the capital flows going? Where's the evolution happening? And where are the returns still able to be accessed like they were?

Robert Morier: What does that education process look like for your clients, then? I mean, we've talked about this institutionalization of the retail market, if you will. So, what does that education process look like, getting them to understand the concepts, the strategies, the illiquidity, the potential for compressed returns, lower return expectations? So how does it all come together?

Christopher Schelling: Yeah, it's hand-to-hand combat. I mean, it's a lot of writing. It's little white papers. It's blog pieces. It's creating collateral for them. We're in the process of, right now, a big deck that our advisors can use and shorted as needed, client by client. We're on calls with clients and prospects a lot, walking them through some of those philosophies. And we might even do things more like webinars like this, where we can speak directly to multiple clients at once. But again, there's no short answer. It's just, get out there and do it.

Andrew O'Shea: Chris, as you're looking at the private alternative landscape… and I'm sure it varies by client… are their themes of opportunity or areas your team's focused at the moment in terms of sourcing?

Christopher Schelling: Yeah, so two big ones, one's, maybe, a bit more bottoms-up. One's a bit more top-down. On the top-down-side, we're in market with an opportunistic real estate fund slash fund-to-fund. It'll be half funds, half co-investments. This is a mix of where we're seeing opportunities from managers, from sponsors, from fund-less sponsors. But it's also just a thesis that there's a big dislocation that's just getting started in real estate, I mean, office being the tip of the spear. But when interest rates go from zero to five, there's a lot of stress that's been created. And so, we're going to deploy that capital over the next, call it, 18-ish months. We've had a couple of closes in that fund. We've got a couple of investments already in the fund. So that's a little bit more top-

down. I mean, like I said, it's a mix of a macro perspective with where we're seeing opportunities. The more bottom-up one is from a portfolio construction perspective, where we're just leaning into buyout. Historically, we've been a bit more over-indexed towards VC for a number of reasons. And if I were to look at our client portfolios, I think there's more of a need for buyout currently. And within that… again, not surprising, given my prior comments… we're focusing on the lower-middle market. So, we've got a lot of funds in the pipeline for that.

Andrew O'Shea: Within the opportunities you're seeing across the real estate spectrum, would you include real estate credit as part of that?

Christopher Schelling: So, we have real estate credit in the portfolio, in a couple of different spots. I would say this particular vehicle has a specific cost of capital that's going to be very opportunistic. So, it's equity. If we will do a credit strategy within that, I would call it, what I like to refer to as credit for the sake of equity. So that would be a distressed kind of opportunity, where you're buying a fulcrum security and owning it through a bankruptcy process because you want to own the asset for an equity return.

Robert Morier: Right. When you look at the buyout space, for example, how do you go about sizing those manager exposures? So, you talked about the super-markets, and then you talked about the specialty shops, which is a significantly lower proportion of the overall asset base. So how do you go about sizing those allocations?

Christopher Schelling: Yeah, honestly, our sizing is just pretty consistent. What we're trying to do is build a portfolio. And so, we're not really making conviction bets per se. What we're doing is, if we would have, say, 100 million… just for the sake of argument… and we want, maybe, 10 investments because we're going to be focused on sector specialists, smaller funds that have an industrial tilt or a telecommunications tilt or a financial services or health care tilt, we're going to want eight to 10 of those, and so we're going to size them 10 to 12 million. We might, maybe, make a risk tilt to it. It won't be a conviction bet. It'll be if you're a little bit of a safer hand, a more diversified portfolio, your lower loss ratio, more consistent returns. We might go a million or more. If you're more of a chunky portfolio, you've had more dispersed outcomes, bigger winners, a couple of losses, we might size down just a bit. But it's pretty much just an equal weighting approach.

Robert Morier: Is that risk factor analysis something that you introduced or is it something that's been in—

Christopher Schelling: No. I mean, that's been part of the process, is just assessing how risky the manager is and how they fit inside of the portfolio.

Robert Morier: Well, it helps me with my question around risk management, so I appreciate that very much. Well, given your experience and success, it's a highly competitive industry, as we all know. Andrew, out on the road, raising assets, you, looking at all of these managers. What advice do you typically give to young professionals who are entering the field for the first time? You get a lot of calls. You have a lot of opportunities to be able to deploy capital to really interesting managers with good stories. So, what's the advice that you're giving?

Christopher Schelling: I mean, it obviously depends on a lot on what they want to do and what they're good at, back to the motivation. For those that are interested in alternatives or interested in private markets, I do think starting your career with a big institutional allocator or an investment consultant firm is a very good start because you can see a lot. Those seats are expansive. You're working with big clients. You're working with big capital pools. You get access quickly to key decision makers. And you get to meet a lot of great GPs. The best advice I could give to anyone in that seat is just get your reps up. Meet as many managers as you possibly can. You don't know what good looks like until you've seen lots of good, a lot of mediocre, and even some really bad because then you can go, ah, they don't do it, and they're really bad. So, I guess those processes that these other ones do really is important. And you can do that on the institutional side because of the scale there. So, it's a great place to get started at a pension, at your local university's endowment because you can learn a lot there.

Robert Morier: You talked about areas that you're focused on in terms of asset class. How do you have a bigger picture, just as you look ahead to 2024? We're about to wrap up the first quarter of this year. There's a lot of news that's ahead of us as we look at the next nine months. So how are you capitalizing on some of those events that are set to happen or maybe avoiding?

Christopher Schelling: Yeah, so I'm going to disclaim, I'm not a macro guy. And I'm not really a capital markets guy. I'm really focused on consistently deploying into private markets because I think that's super critical. I've not seen evidence that people can be very tactical. This is a bad vintage. I'm not going to deploy. If anything, hire managers that have done a good job, historically, of when to slow down and ramp up and exit. So, we're consistent in terms of putting private capital to work across our portfolios. But my big-picture belief that things are probably a little bit worse this year than they were last year. Coming into last year, I thought everyone was overly concerned with an imminent recession. This year, I think people are overly sanguine. If you just look at risk metrics, they're kind of all extended. The Cape ratio, the Cape Shiller or PE ratio is at its third all-time high. Volatility is below 13. Dispersion amongst individual stocks in the S&P is at almost an all-time low. You have things like gold peaking. You have Bitcoin peaking. It just kind of feels like risk premiums are extended right now, and people are a little bit more sanguine. We are seeing clear signs of distress in credit… maybe not distress yet. That's

too strong a word, but defaults have increased. In the private side, they were at zero for five years. Now, they're at 1% or 2%. In the syndicated bank debt market, they were at 2%. Now they're at 6%. And so, we're not at recessionary levels, but from being well below historical norms, we're back at that or above it. And it's trending in that direction. So, I think this year could actually see some bankruptcies, some defaults. And people should be prepared for that. I just have a tendency to get a little bit more concerned when everyone else is really sanguine, yeah.

Andrew O'Shea: You bring up an interesting point. I talk to a lot of firms similar to yours around the country. And it's like, private credit, private credit, private credit is coming up constantly, and it makes you wonder, is there too much capital going into that space? What's the opportunity set for private credit going forward?

Christopher Schelling: I think similar to private equity. I mean, that's gone from $100 billion to 1.5 point trillion in 10, 15 years. And a lot of that capital has been… if you just look at the AUM, 50%, 60% of it is senior-secured, sponsor-backed direct lending strategies, the core market. Now, again, that can, I think, absorb a lot. Just look at the size of that. It's $1.5 trillion. OK PE's 3 and 1/2 trillion of dry powder. The typical PE structure… so a buyout is 50% debt, 50% equity. So, if you've got 3.5 trillion of private equity dry powder out there, looking to buy companies, it's going to need 3 and 1/2 trillion of debt because that's just the equity side of it. And so, your private credit industry is not even big enough to meet all that demand. Now, yes, there's bank loans. There's high yield beyond it. I think that this can continue to scale. Now, that doesn't mean there's going to be idiosyncratic credit events within there because there are. Bain had a great research report they release every year, their global private equity report. Highly recommend it to students or people who want to learn about private equity. In there, they track interest coverage ratios of privately-owned businesses. Last year, more than 80% of businesses had greater than three times interest coverage. Now it's less than 20%, just one year later. And so, the stress is happening, and I think we're going to see that, but I don't think that means private credit is done. This is an asset management business now. It's going to continue to scale alongside private equity, and it's got a long runway in front of it.

Robert Morier: Thank you for sharing that. These are the episodes that I regret we put an hour cap on the conversation, so thank you for sharing all of that. Just a couple more questions for you. We're always curious the people who impacted your career, the mentors along the way. Who are some of those folks? You mentioned a professor earlier in the conversation.

Christopher Schelling: Yeah, J.B. Kurish got me started down this path, but I would name two. I always name the same two. They were colleagues at Ennis Knupp, which was a consultant firm back in the day. But Keith Black was my professor at IIT. So, I went back to get a master's in finance because I was told by a colleague that an MBA will make you a

better analyst, but it won't make you an analyst. So, I went to get the MS in finance, and Keith was a professor there. And he is now at RIA Intel, designing classes on alternative investments. He was at the CAIA for a number of years. He really helped me own a research-driven and analytical approach. And honestly, a lot of the stuff I do is, how would a Keith approach this problem? How would he go about getting information? And then the other would be T.J. Carlson, who I worked for at Kentucky and Texas Municipal. And T.J. is probably the best manager of investment teams. And so, I learned the personal side, how to work with people and think through motivations and put those puzzle pieces together on the team.

Robert Morier: That's wonderful. Thank you for sharing that. I'm going to ask you one more question. It's a question that a behavioral psychologist asked me, so I think it's apropos, given all of the conversation. So, what is a decision in your career that you're most proud of?

Christopher Schelling: A decision that I'm most proud of. I don't know. I don't think there's one. I would say the fact that I'm most proud of or, I guess, the outcome that I'm most proud of, between Kentucky and Texas Municipal, the three portfolios that I worked on, the teams that we worked together to build those portfolios, we created almost a billion dollars of excess return, not nominal returns. And that actually adds to the funding status. If you do the actuarial math, that's something like 50,000 years-worth of retirement checks that my team's helped pay for at those two institutions. So that's something that I'm most proud of because that's real-world impact. I mean, those are retirees that are 63 years on average. They get a $20,000 a year pension check, and we helped secure that for them.

Robert Morier: Chris, thank you for being here in Philadelphia. Congratulations on all your success. This was a great conversation. Andrew, as always, thank you for your questions, and thank you for being here. If you want to learn more about Chris and Caprock, please visit their website at www.caprock.com. You can find this episode and past episodes on Spotify, Apple, or your favorite podcast platform. We are also available on YouTube, if you prefer to watch while you listen. If you'd like to catch up on past episodes, check out our website at dakota.com. Finally, if you like what you're seeing and hearing, please be sure to like, follow, and share these episodes. We welcome your feedback as well. Chris, thank you again for joining us. Andrew, thank you as well. And to our audience, thank you for investing your time with Dakota.