PRIVATE MARKETS – LOW VOLATILITY AND HIGH RETURNS ARE POSSIBLE

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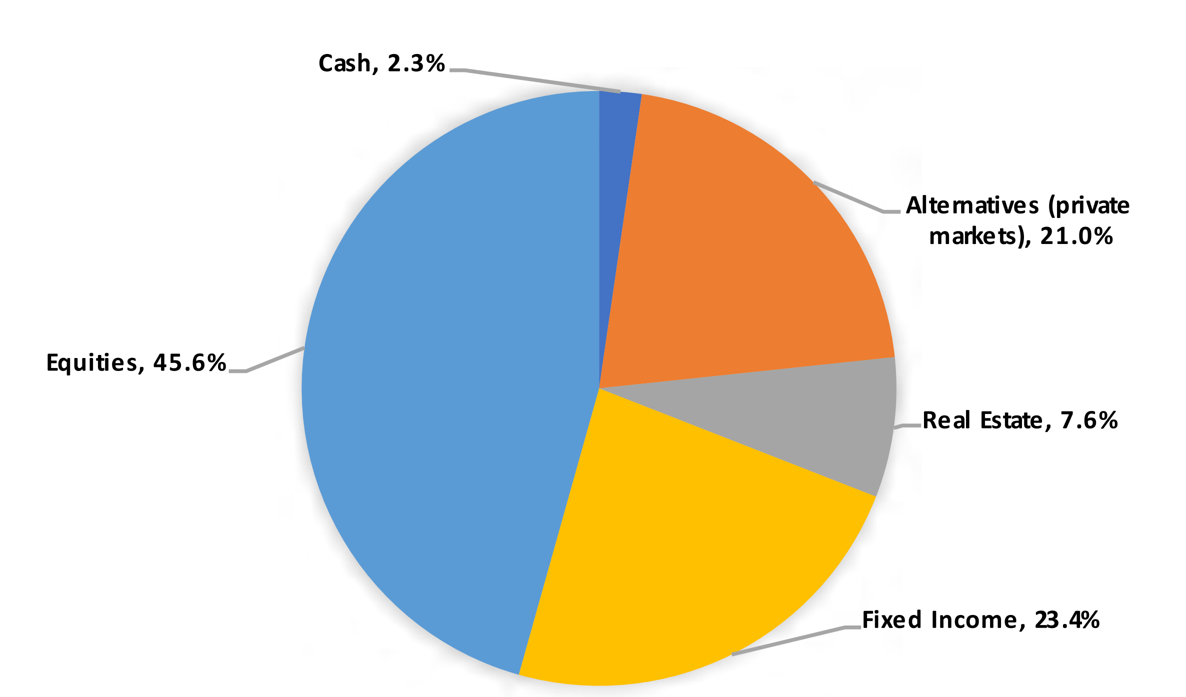
Investors, even those focused on long-term returns, often battle their emotions as they face wild swings in the markets and fear losing hard-earned money. Fear may often get the upper hand, causing investors to lock in losses, while greed can push them into buying assets at high prices. Both result in lower returns over the long run.

Pension and sovereign wealth funds have known that for decades and have increasingly incorporated private market strategies into their overall asset allocation. In fact, for the first time last year, the average allocation to 'alternatives' (mostly private market funds) exceeded 20% of the reported holdings of US pension funds according to the National Association of State Retirement Administrators (NASRA). This represented a ten-fold increase in the allocation to these strategies from the nearly 2% average NASRA reported in 2001. The rising share of alternatives in the asset allocation strategies of pension funds in the US happened in tandem with a reduction in the expected return of their portfolios to 7.4% from 8% over the same period.

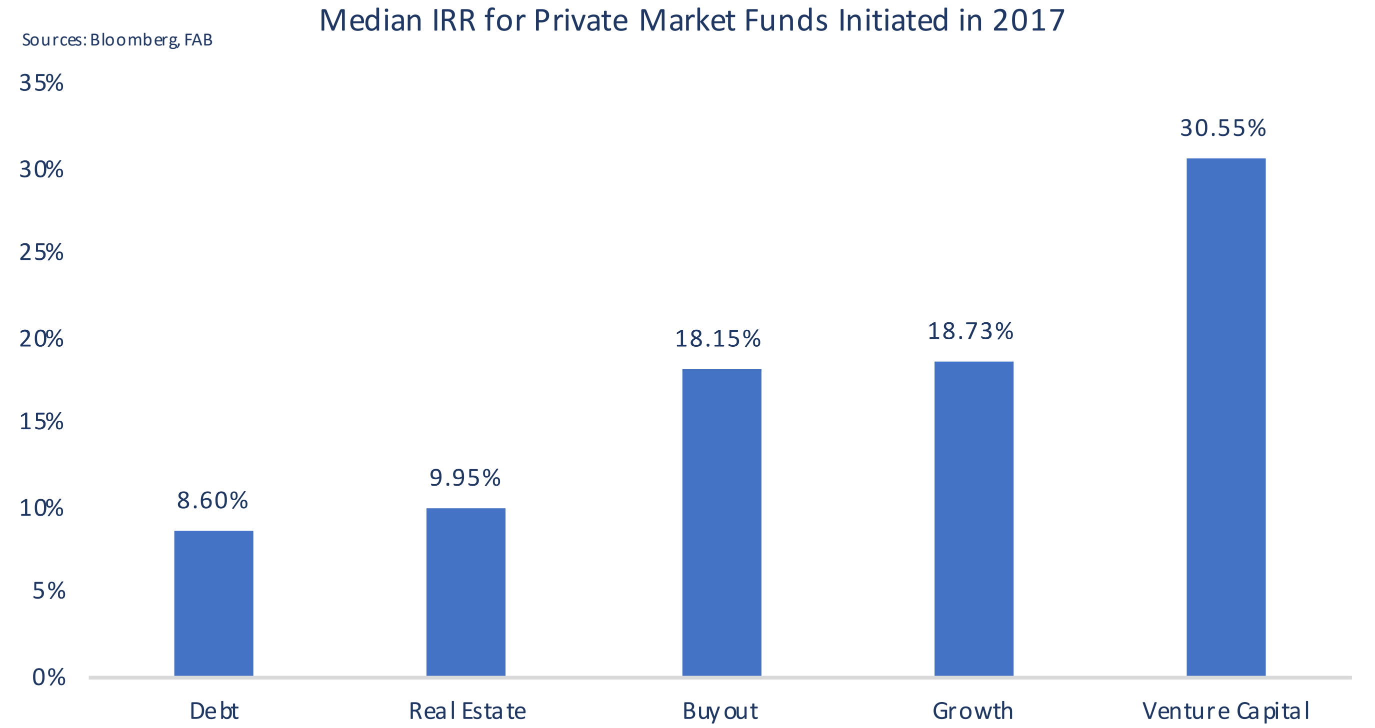


Sources: National Association of Retirement Administrators, FAB

This is not a coincidence. As interest rates were pushed ever lower and the average returns on public market securities fell, pension funds increased their allocations to private market strategies, which can generate equivalent or higher average returns with lower volatility. The median annual return for private equity funds, for instance, was 13.3% between 2007 and September 30th 2020 according to McKinsey & Co., or double the 6.5% average annual compound growth rate of the S&P 500 index over the same period.

The same pattern can be seen across other private market strategies. For instance, private credit funds generally perform better than their fixed income counterparts (in fact, they were up last year when fixed income was generally down). Similarly, direct real estate funds have done better than REITs, while real asset strategies have generally performed better than direct investments in many commodity funds.

The only exception might be selected technology stocks, which have become market darlings in recent years and have powered equity index returns in the US, but even they did not beat their private market counterparts by much. The NASDAQ 100 index had a stellar 228% performance between the end of 2016 and December 1st, 2021, equating to a 34.65% compound annual growth rate compared to a 30.55% average internal rate of return for venture capital funds created in 2017, according to Bloomberg.



Sources: Bloomberg, FAB

The additional gains, however, came with much higher volatility. For instance, in the past two years, the NASDAQ 100 fell by more than 10% three times, and there were three drops of more than 7%. Meanwhile, venture capital firms, for instance, arguably did not face the same ups and downs. Granted, that is partly because the assets they hold are not publicly traded so there is less transparency about returns, but the final outcome is what matters. Investors, however, need to understand these nuances before they venture into the private world. Here are a few key differences to look out for:

Liquidity

Part of the reason that public markets are more volatile is because they are more liquid and operate on the basis of daily price discovery. Investors can buy or sell equities or bonds in a company during the same trading day with settlement taking a few days. Meanwhile, with private market investments, money committed may not be paid back for several years, and investors are likely to have little visibility apart from quarterly (or sometimes even annual) reports they receive from the fund management firm about how cash has been deployed.

There can be at least some liquidity, though. An investor may be able to sell the participation in a fund in the secondary market, but any sale could be at a loss, depending on the stage of the investment deployment and the time to expected redemption.

Availability of cash

The normal investment horizon for private equity programmes tends to be around seven or eight years. That is usually when investors can expect to get their money back, although there may be some payback towards the fourth or fifth year depending on a variety of factors. Private credit funds could be a bit faster as loans made start to earn interest and be repaid, while venture capital can take longer as the underlying businesses funded arrive at possible 'exit' points (for the manager) via IPOs, LBOs or strategic sales.

This is why private market managers talk about internal rates of return instead of yields or straight returns. Funds calculate how much they are going to return to investors based on the cash flows, but these do not happen in a straight line like a bond or involve regular dividends like with a stock. Depending on the strategy, investors may commit the cash and wait several years before they get paid and then suddenly receive a big lump sum.

Different Strategies

Private funds usually try to exploit inefficiencies in funding markets or in company management. Private credit funds might offer loans to companies that are having trouble getting them from banks or bond markets. Buyout funds may take over companies that have steady cashflows but that have not managed to extract maximum value. Venture capital firms seed many start-ups, hoping that a few of them will do fantastically well and make up for the majority that fail.

Investors need to understand these aspects before entering various strategies to avoid getting worried without reason. For instance, a venture capital firm might have seeded several failed companies in its portfolio, but that does not mean it will be unable to return investors' capital plus gains.

Here is a simple guide to some of the most popular strategies:

Buyout

This usually involves acquiring mature companies that have steady cashflow, and using leverage and cash management strategies to improve the equity value of the company. Often private equity firms that focus on buyouts will have identified future strategic buyers or an opportunity to resell the company they acquired in the capital markets after they have improved its cash-generating capability.

Venture Capital

This focuses on companies that are in early stages of growth. Such firms are often focused on technology, given that this is the sector that has seen the highest growth over the past two decades. However, venture capital firms may find opportunities in other areas that do not involve technology, but which should benefit from areas of high growth such as, for instance, a new trend. This was recently the case with firms that invested in companies that offered plant-based alternatives to meat.

Most venture capital firms seek to make several investments in areas they believe will see strong growth, usually in companies that have already received a couple of rounds of financing and have therefore started to mature. Many of the investments will fail, but it only takes one good investment in a vintage to work out and make the entire investment worth it, given the multiples that can be generated.

Credit

Private credit is a broad name for many sub-asset classes, including distressed debt and mezzanine financing. Many private credit firms specialise in offering loans to private equity firms, but some will seek medium-sized companies or those that are going through a tough period and may have difficulties accessing bank credit.

One of the advantages for investors is that these firms usually offer very senior lending, meaning they are at the top of the capital structure in case the borrower ends up in bankruptcy. The result is that even when there are defaults in a portfolio, private credit firms are usually able to recover a significant part of what they lent by taking over assets pledged against the loans.

This strategy also tends to pay investors back faster and to start paying coupons early on. Plus, loans offered by private credit firms are usually based on floating rates, so they are mostly immune to changes in benchmark interest rates.

Real Assets

Again, this category has several sub-classes, including real estate, infrastructure, art, and commodities. As the name suggests, this strategy focuses on tangible assets and trying to acquire them at a discount.

Conclusions

There are many other strategies and subcategories in the private markets space. One thing is common to all though: they target high returns, which are likely to have low correlations to public markets and which therefore deserve a place in most portfolios. And, as global pension funds are increasingly realising, they should probably become an even larger part of the long-term assets that they manage.

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