Unlocking the Potential of Investing in Private Markets

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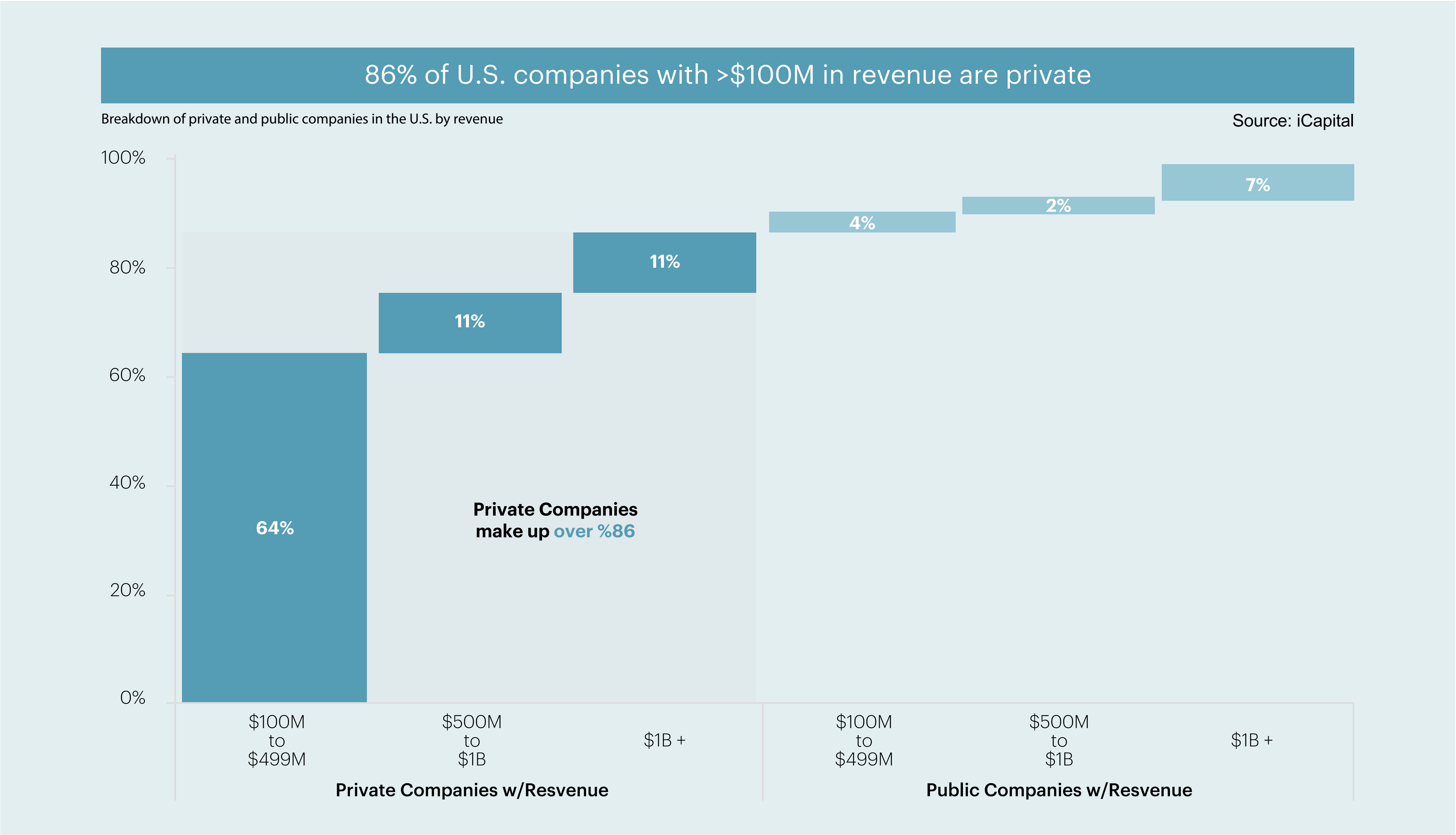
Risk and return are generally at opposite ends of the spectrum. If one expects the highest possible return, then one must be willing to risk the invested capital. A capital-guaranteed raffle ticket does not exist.

Maximising returns for a given level of risk or reducing risk for a given level of return has often been considered the holy grail of wealth management ever since Harry Markowitz, winner of the Nobel Prize in economics in 1990, brought about a paradigm shift in portfolio management.



While investors have become quite comfortable with investing in public markets, the world of private markets tends to be less understood. However, the investment universe for private assets is vast, deep, and much larger than public markets.

There are about 20,000 publicly listed companies worldwide generating more than USD 100 million in revenue. In contrast, the number of private companies generating the same amount of revenue is more than seven times higher. Therefore, statistically speaking, investors are more likely to find opportunities to achieve superior returns in private than in public markets.

This article aims to provide a basic understanding of private markets and how they can add value to an investor's portfolio. It also covers some high-level points about the risks of investing in private markets, how global macro trends impact investment returns, and how an investor can access private markets.

What constitutes private market investments?

Private market investments are investments in assets not publicly traded on common exchanges, such as private equity, private credit, venture capital, real estate, and infrastructure.

Unlike public markets, where securities can be bought and sold on exchanges openly, private markets involve transactions directly negotiated between parties, often with less regulatory oversight and greater flexibility.

The growth of assets under management (AUM) worldwide has been phenomenal since 2010 and is expected to continue growing significantly. According to a report by iCapital, AUM in private markets is set to grow at a compound annual rate of about 10% until at least 2029, offering potentially immense opportunities for investors.

Types of private market investments

Private equity: This involves buying stakes in companies that are not publicly traded or taking publicly traded companies private by buying out the shares of existing shareholders. Private equity firms typically acquire a significant stake in a company to improve its profitability through operational or strategic measures, eventually exiting the investment through a public offering or a sale at a profit.

Global Assets Under Management (AUM)

Cumulative AUM by asset class, 2010 - 2029E ($ trillion, as of March 2024)

Source: iCapital

The most popular type of private equity investments

- **Venture capital**: Funding early-stage companies with high growth potential. This investment type has gained immense popularity over the last few years given its multi-fold returns. However, it is associated with extremely high risks, requiring venture capitalists to become involved, who often actively guide the company's development.
- **Distressed/turnaround**: Investing in companies struggling financially to restructure and improve their performance.
- **Secondaries**: Buying existing stakes in private equity funds from other investors.
- **Buyouts**: The acquisition of a controlling stake in a company, often financed with substantial leverage or borrowed funds.

Private credit

Also known as private debt, private credit includes loans and advances provided to companies outside traditional banking channels. It can also take other forms, such as direct lending, mezzanine financing, and distressed debt.

Types of private credit:

- **Direct lending**: As the name suggests, this involves providing loans directly to companies at mutually negotiated and agreed upon terms.
- **Mezzanine financing**: A mix of debt and equity that gives the lender the right to convert debt into equity in case of default. Also known as subordinated financing, mezzanine financing is typically not secured by the company's assets, and it ranks below secured debt in repayment priority in case of default.
- **Special situations**: As the name suggests, this involves lending to unique or complex transactions that do not fit into traditional lending categories.
- **Asset-based lending**: Loans disbursed under this category are secured by the company's assets, such as inventory or receivables.

Real estate: Investments in residential, commercial, or industrial properties to generate stable income through rent and/or the potential appreciation in property values.

Infrastructure: Investments in critical public infrastructure such as transportation, utilities, and communication networks. These investments often provide long-term and stable returns because these assets are essential.

However, the question remains: How do these investments add value to the portfolio? The short answer is in various ways. Here is an overview of a few:

- Diversification is one of the benefits of private market investments. Private market investments are typically less correlated with public markets. Adding these investments to public portfolios often reduces portfolio volatility and enhances risk-adjusted returns.
- Illiquidity, or the lack of liquidity, is one of the characteristics of private market investments. The compensation for illiquidity comes in the form of a premium on the returns. This has led to historically higher returns than public markets over a longer time frame.
- Illiquidity, or assets that cannot be easily converted into cash, is predominantly due to the long-term focus of many managers in private markets, who adopt a buy-and-hold strategy. This helps align the long-term interests of both investors and management, leading to value creation. This long-term focus can lead to more stable and predictable returns.
- Private markets offer access to unique investment opportunities that are not available in public markets. This includes investing in innovative startups, niche sectors, and distressed assets with turnaround potential.

Going back to Markowitz and the efficient frontier, allocating private market investments into a traditional portfolio may offer comparable volatility with greater returns than a more conservative portfolio while potentially preserving value and serving as an effective volatility buffer in a more aggressive portfolio.

However, presenting an overly optimistic view of private markets without explaining the associated risks would be remiss. Investments always carry a risk, and private markets are not immune to this, so what are some of the major risks of investing in this asset class?

- Private market investments are traded less often, particularly during unfavourable market conditions, so the key risk of investing in private markets is illiquidity.
- Some private market investments are subject to lesser regulatory oversight and disclosure requirements than public investments, so some have a lower level of transparency.
- Some private market investments have a long investment horizon.

This is particularly true in the case of private equity investments, where the commitment period tends to be longer, which can be particularly challenging for investors seeking liquidity.

- By nature, private market investments are complex and require more due diligence and expertise to manage them effectively.

After examining private assets, their advantages and limitations, and how some known macro trends affect them, let us focus on two basic structures through which they are offered to investors.

Whenever one sits down with a financial advisor to discuss investing in private assets, they will offer various investments to select from. Most of these investments follow one of the following two structures.

Private market structures: Drawdown structures

This structure is the traditional way of investing in private assets. Investors are presented with a concept or an underlying philosophy for the investment, along with a portfolio manager's track record and the manager's strength in identifying investment opportunities. The portfolio manager draws down some or all the investments committed to over a multi-year investment period and uses that to acquire assets for the portfolio. By the end of the fund's life, the portfolio manager will generally aim to sell the assets and distribute the proceeds to investors.

The investment opportunities available for drawdown structures are vast. While this competitive advantage is diminishing, it remains an advantage for drawdown structures — at least for now. One of the other advantages of drawdown structures is that the portfolio manager is not pressured to deploy the funds immediately. The portfolio manager can scout for new investment opportunities and call for capital once the ideal investment fit is identified.

However, investors must understand that these funds operate largely in the illiquid space. The fund's drawdown structure is designed to match the liquidity profile of the underlying investments. The yield in the case of credit investments and realisation from exits in the case of private equity generally provide liquidity. The standard time frame for investing in these structures is eight to 10 years.

Evergreen structures

These structures have no fixed end date and allow investors to make ongoing investments and redemptions — albeit with some restrictions. They are accessible to a wide range of investors and provide enhanced liquidity. Portfolio managers can easily implement them, and investors can get immediate exposure to various asset classes with a lower minimum amount of investment capital required.

The advantages of the evergreen structures include:

a) The structure reduces the J-curve effect[1], especially in private equity, where return profiles are back-ended.

b) The structure tends to minimise the blind pool risk. Given the continuous subscription and redemption option of evergreen funds, investors can buy into a fully invested portfolio, unlike the case of drawdown funds, where investors may not own any investment when they commit capital to the fund.

The evergreen structures have drawbacks and are not the panacea for all investors. Redemptions are usually limited to 5% of the fund's net asset value (NAV). They must often be given a 90-day notice period to the portfolio manager. And if all investors in a fund exercise their right to redeem simultaneously, then the redemptions might become pro-rated. This also means significant redemptions affect the fund's performance, and the remaining investors normally bear it. Finally, a mismatch between deal flows and cash availability in the fund leads to missed investment opportunities or a performance drag due to unused cash.

We believe both evergreen and drawdown structures can help investors achieve superior returns and diversify their portfolios. This is why, at FAB, we offer both structures within private assets to complement investors' portfolios.

In conclusion, private assets offer unique investment opportunities. They can add significant value to investment portfolios through diversification, higher returns, and access to unique assets. However, the key risks are illiquidity, a long investment horizon, the complex nature of these investments, and less transparency and regulation. Additionally, like all investments, returns from private assets are influenced by macroeconomic trends such as interest rate fluctuations, economic cycles, inflation, technological advancements, and geopolitical risks.

However, by understanding the nature of private markets and anticipating macro trends, investors can better navigate the complexities of investing in private markets. Staying informed and being willing to adapt is key to investing in this dynamic and ever-evolving landscape of private markets.

[1] J Curve: Definition and Uses in Economics and Private Equity