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A Look Inside an Elusive Investment Alternative

Private markets. Sounds like a secret club.

And in many ways, it is—but today we are going to lift the veil of secrecy and let light in upon the mystery. To help break down this complex topic, we have Senior Portfolio Manager Jordan Strauss and Senior Research Analyst Julian Freeman.

Julian Freeman, CFA
Senior Research Analyst,
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Let's first lay out the basics. Julian, what exactly is meant by private markets investing—and how does it differ from public markets?

A. Private markets (PM) fits within the alternatives asset class.* It's outside of the traditional stock and bond world, where information is often readily available. Here, investing generally involves providing equity (buying an ownership interest) or debt (loaning money) to companies that aren't traded on public exchanges. To gain access to this exclusive space, investors generally participate in a PM investment fund. PM funds are typically structured as drawdown funds, where a limited partner (the investor) will make binding commitments of capital that the general partner (the fund manager or GP) will call down for investments over what's referred to as the fund's commitment period, ordinarily around three to five years. Following the commitment period, GPs seek growth and value creation of the portfolio companies they own. As GPs exit investments, they seek to return capital to limited partners.

A key distinction between public and private markets is that the latter offers access to far more opportunities. There are over 6,000 publicly listed stocks traded on U.S. exchanges[1] (a number that has been declining), but there are over 700,000 private companies in the U.S. with more than 20 employees.[2] With such breadth of opportunity, PM fund managers often deploy focused strategies, targeting companies that would benefit from their specialized knowledge and core competencies. Ultimately, investing in PM has offered the opportunity for higher returns than portfolios with only public markets and/or increased portfolio level diversification. These are often the factors that drive investors to consider PM investing.

*Investments that focus on alternative assets are subject to increased risk and loss of principal and are not suitable for all investors.

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And can anyone invest in private markets?

A. No, an investor needs to be a qualified purchaser and/or accredited investor by meeting certain minimum requirements related to earned income and/or net worth, which is defined by the U.S. Securities and Exchange Commission (SEC).

Jordan Strauss, CFA
Senior Portfolio Manager,
Wilmington Trust
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Jordan, what kind of private markets strategies are there?

A. **Private equity** strategies include buyout, where a GP will purchase a majority interest in an established company, work to improve profitability or grow the business, and then sell it. At the other end of the spectrum is venture capital, where managers make minority investments in early-stage startups, with a limited operating history and at times not even any revenue or profit. Growth is a strategy in between the two, where the manager provides equity capital to a fast-growing business, typically to expand the business and support future growth.

Private real estate, where managers own equity in properties, can comprise a number of different property types and risk profiles. Major property types include offices, apartments, warehouses, retail, and hotels, and there are managers who have specialized mandates in property types such as medical offices, self-storage, and senior living. In terms of risk profile, core assets have the least amount of risk and involve investing in stable, high-quality assets located in major metro areas that are expected to produce stable income with minimal improvements. In the middle of the risk spectrum are value-add assets, which generally require some type of improvement to maximize the value of the asset and its cash flow generation. Buyers usually have an improvement plan for the asset prior to purchase and may utilize more leverage in order to implement the improvements. Opportunistic projects present the highest risk and typically involve heavy repositioning or ground-up development.

Private debt comprises direct lending to companies, mezzanine financing (which involves making subordinated loans while often also taking a small equity interest), and distressed debt (where companies are either close to default or have defaulted). This is just a broad sweep. There are many other types of PM as well, including special situations and niche strategies, like litigation finance.

And why might qualified investors want to add private markets to their portfolios at this time?

A. In short, PM may provide investors the opportunity to enhance portfolio return and/or lower volatility and increase diversification (private and public markets have not necessarily moved in lockstep). It's important to understand how PM funds seek to target higher returns. Julian mentioned the much larger investment opportunity set, with hundreds of thousands of private companies in the U.S. This, combined with the reality that there is limited availability of important information on private companies, generally means that PM are less efficient, which provides GPs with the opportunity to gain an informational advantage. Additionally, GPs typically have partial or total control and ready access to capital to support companies which allows for the pursuit of more complex business strategies, permitting major changes and greater value creation. Finally, with long-term

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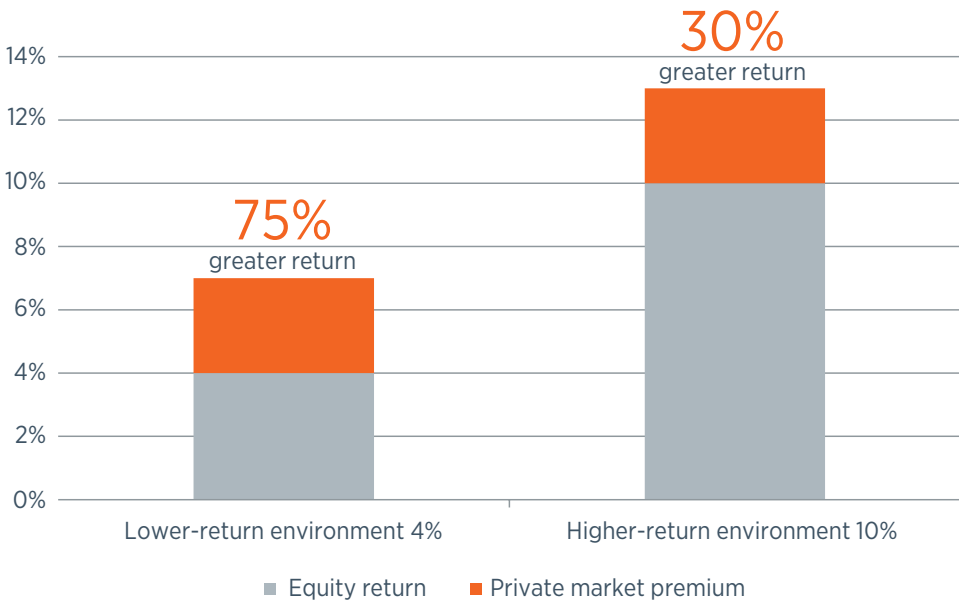
One reason investors may want to consider PM now is that, given the strong return environment for equities and credit since the 2008 financial crisis, we believe return expectations going forward will be more muted in public markets. The expected outperformance of PM is more valuable in environments with lower return expectations overall.

Figure 1
Why private markets today

- Given the strong environment for equities and credit since the 2008 global financial crisis, we believe return expectations going forward are more muted
- Outperformance is more valuable in periods when returns are low



This table is for illustration purposes only and does not reflect the actual past or future performance of any specific investment. The illustration is hypothetical and is intended solely to depict how different rates of return can affect lower-return and higher-return environments.

What's more, PM outperformance has historically been greater in weak environments. Figure 2 shows the excess return provided by private equity[3] relative to public equities given four different buckets of return outcomes for the S&P 500. In negative and lower return environments, where the S&P was up less than 10%, private equities have provided the most outperformance.

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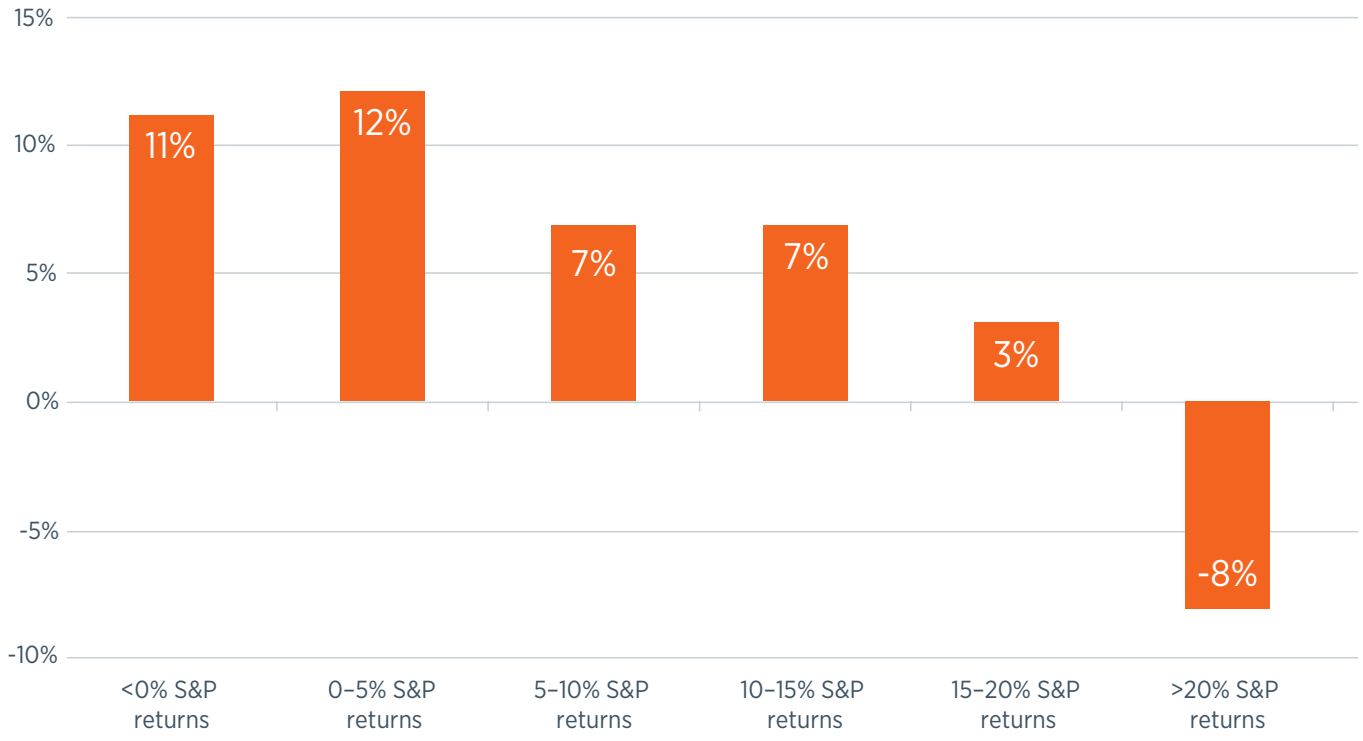
Figure 2

PE average relative returns in various market environments



Source: Cambridge US Buyout Annual Returns vs. S&P 500 Annual Returns, 1987-2020.

Past performance cannot guarantee future results. Indexes are not available for direct investment. Investment in a security or strategy designed to replicate the performance of an index will incur expenses such as management fees and transaction costs which will reduce returns. See the end of this article for more information regarding indexes.

But there are risks, right? Please share a bit more about this, Julian.

A. In most cases where there is potential high reward, there is high risk. Unlike publicly traded investments that can be quickly redeemed if liquidity is needed, PM capital is typically locked up for a number of years. The lack of exit options and the complex strategies employed in the operation and capital structure of these companies means that private investing attracts capital from investors who are comfortable with measuring their results over five to ten years or more. What's more, PM funds are not subject to the same SEC registration as mutual funds, which means they are illiquid and speculative in nature and there can be greater use of leverage. Investors have less transparency on underlying investments, often committing capital to a fund prior to the fund having made any investments. For these reasons, it is important to maintain a continuing, comprehensive due diligence process.

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At a high level, Jordan, how does Wilmington Trust approach PM investments?

A. Our Manager Research Group's objective is to bring Wilmington Trust clients compelling private market opportunities. Our focus is to align with what we believe are skilled investment managers and to invest alongside institutional allocators, including Ivy League endowments, large state and corporate pension plans, sovereign wealth funds, etc. Each year, we aim to diversify our private market opportunities: three recent offerings include a multi-family value add real estate fund, a software-focused growth equity fund, and a direct-to-consumer growth equity fund.

Our clients generally invest directly into PM funds rather than through feeder structures that would typically add another layer of fees and expenses. What's more, we do not as a rule add fees to PM funds, nor do we receive fees from the funds that are part of our PM program, which we believe can help prevent potential negative selection bias (i.e., GPs that would not otherwise be able to raise their target fund size might turn to a firm that's willing to direct client capital toward the fund in exchange for a share of the fees).

For those who want to learn more, what should their next step be?

A. We encourage readers to have a conversation with their investment advisors who know them, their unique circumstances, risk tolerance, and a litany of other factors so they can make a careful, holistic assessment as to whether PM might be a compelling portfolio enhancement.

[1] https://www.statista.com/statistics/265285/number-of-listed-companies-on-stock-exchange-in-the-americas/

[2] https://www.naics.com/business-lists/counts-by-company-size/

[3] Based on the Cambridge Associates LLC US Private Equity Index®, a horizon calculation based on data compiled from 1,468 US private equity funds (buyout, growth equity, private equity energy and subordinated capital funds), including fully liquidated partnerships, formed between 1986 and 2017.

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The S&P 500 index, or the Standard & Poor's 500 index, is a market-capitalization-weighted index of the 500 largest publicly-traded companies in the U.S. It is not an exact list of the top 500 U.S. companies by market capitalization because there are other criteria to be included in the index. The index is widely regarded as the best gauge of large-cap U.S. equities.

The Cambridge US Buyout index is a horizon calculation based on data compiled from 1,627 funds, including fully liquidated partnerships, formed between 1986 and 2019. All returns are net of fees, expenses, and carried interest.

Private funds are available only to certain investors who meet the specific income, experience, and investable assets thresholds set forth by the U.S. Securities and Exchange Commission's definition of "accredited investors" and/or "qualified purchasers" as necessary. In addition, any offer of such products will be made only in connection with the delivery of the appropriate offering documents which are available to pre-qualified persons upon request. Investments such as private funds that focus on alternative strategies are subject to increased risk and loss of principal and are not suitable for all investors. These types of investments may use aggressive investment strategies, which are riskier than those used by typical mutual funds and you may lose more money than if you had invested in another fund that did not invest as aggressively. You are encouraged to seek professional investment advice prior to making any investment decision. In addition, nothing relating to the material provided should be construed as a solicitation, offer, or recommendation to engage in any investment strategy or other transaction.

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