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Investing in Private Markets

A primer

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For many, the private markets asset class represents a road less traveled. Typically, investors focus on more traditional asset classes, like stocks and bonds, where information is often readily available and digestible, as it can often seem like the path of least resistance. Sometimes, however, sophisticated qualifying investors increase their capital allocations to private markets for reasons they believe are compelling enough to make it worth taking the risk. The search for higher returns, diversifying return streams, and unique opportunities are just some of the key forces driving capital flows into the space. For investors who are less familiar or who have some exposure but remain underallocated, the same rationale may ultimately justify an increased exposure to private markets investing.

Of course, as with all important decisions, there are tradeoffs. Liquidity characteristics and the use of leverage, as well as limited regulation and transparency need to be understood and thoroughly analyzed at both the individual investment and portfolio levels prior to making any long-term commitments. Perhaps even more important is the need for effective manager selection. In conducting due diligence on managers in this space, it is important to consider their specialized knowledge and high level of complexity when it comes to the wide range of strategy types and structures and the high dispersion of returns among top- and bottom-performing managers. Ultimately, the most important decision for private markets investors may be selecting the right general partners.

This primer will provide an introduction to private markets investing, explore key reasons behind why investors allocate capital to the asset class, and evaluate some of the key risks and challenges that potential investors should consider. It will further discuss efficient cash management and the importance of good manager selection.

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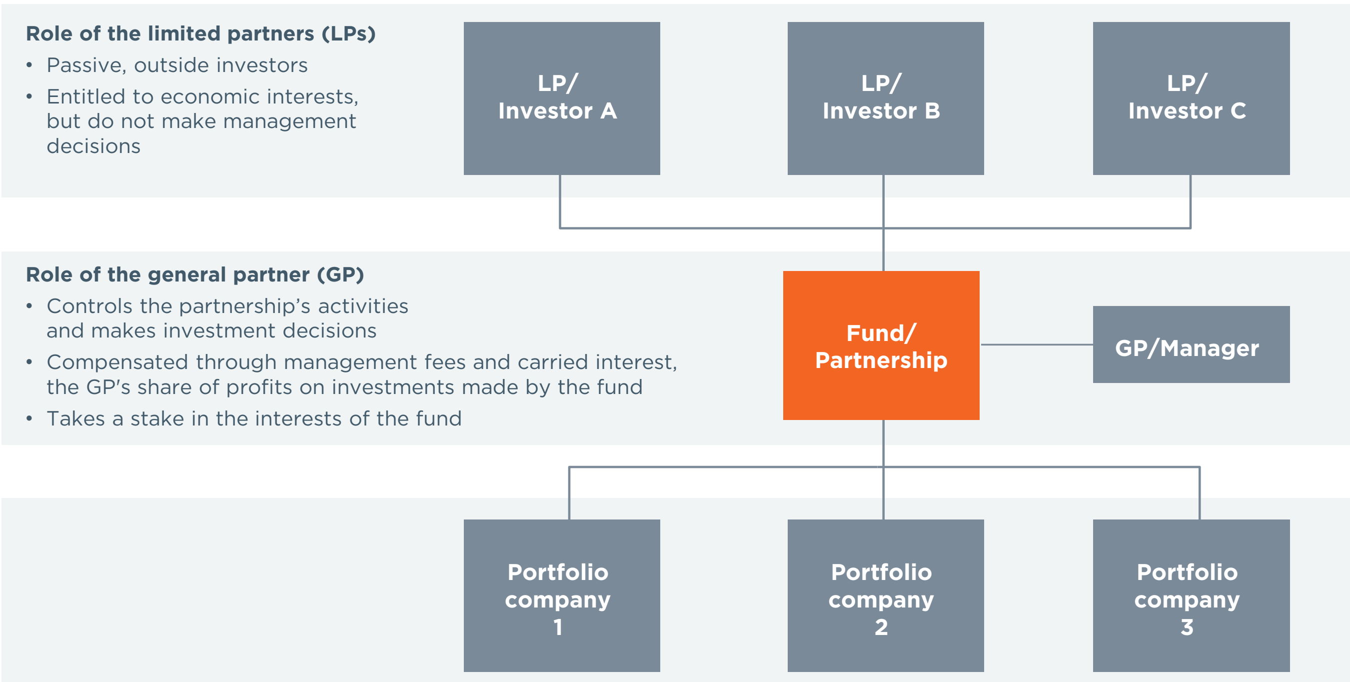
What are private markets

Investing in private markets generally entails providing equity or debt capital to companies that are not publicly traded. Qualified investors—those who meet minimum income and asset requirements set forth by the Securities and Exchange Commission—often accomplish this by investing in a private markets manager's investment fund, typically structured as a limited partnership (LP), or sometimes as a limited liability company (LLC).

Figure 1

Structures and roles



Private markets investments can be categorized as private equity, private real estate, private debt, or niche strategies, though some industry professionals use the term private equity to describe all private markets investments.

Private equity

- Growth/buyout involves investing in established companies with defined products and markets that have some demonstrated operating history of revenue and profit generation.
- Venture capital involves investing in small startup companies, oftentimes alongside companies' founders, with limited operating history and, at times, no profit generation. Generally, a venture fund will make many investments, expecting most to result in a partial or total loss, but with the hope of large outsized returns from investments that are successful, which may result in an initial public offering (IPO) or a buyout by a larger firm.

Private real estate

- 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.

Continued

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- Core plus assets are similar to core, but may benefit from slight improvements. These assets have somewhat higher risk profiles due to issues such as the building age or management inefficiencies.
- Value-add assets 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, which may be in less established secondary or tertiary markets. While these projects have a high potential return, that comes with a high degree of risk (see pp. 9–10 for more on these risks).

Private debt

- Direct lending refers to loans made directly to companies without financial intermediaries, such as investment banks. Direct lending often focuses on middle market companies that may otherwise have limited access to debt capital, providing lenders with yields not available in more traditional credit markets. Some private markets managers focus exclusively on lending to private equity-backed companies. Direct lending firms generally conduct their own due diligence prior to deploying capital, as many hold their loans long term and may provide the borrower with growth support.
- Mezzanine financing blends aspects of debt and equity. It generally consists of making subordinated loans (unsecured junior debt that ranks below secured senior debt) while also taking an equity interest. Mezzanine financing can provide capital beyond senior secured debt and may be used for leveraged buyouts, recapitalizations, and corporate acquisitions, as well as an alternative for companies seeking growth capital.
- Distressed debt investing involves investments in the obligations of mature companies that either have defaulted or may default on debt in the near future. Investors lend to these companies despite the risks and complexity because they are often able to purchase the debt at a significant discount to its par, or nominal, value. Investors may believe the company has a strong businesses model with a cash flow problem and that a turnaround is quite possible. They may, therefore, seek to gain control to implement a strategy they believe could effect such a turnaround. In cases where these companies do ultimately succeed, investors can generate outsized profits. Distressed debt investing involves significant risk and requires experience and expertise.
- Special situations frequently involve investing in the securities of a company for reasons other than the fundamentals of the business, such as corporate spinoffs, carve-outs (when the parent company sells shares of a subsidiary to existing shareholders), litigation, or other event-driven/opportunistic investments.

Continued

Figure 2

Hypothetical cash flow stream (J-curve)

Investment lifecycle may vary.
Source: WTIA.

This figure is for illustration purposes only and does not reflect the actual performance of any specific private market investment. The illustration is intended solely to depict the hypothetical lifecycle of a private market investment. The hypothetical lifecycle is not intended to be indicative of the past or future performance of any specific investment. It is possible to lose money in a private market investment.

Niche strategies

- These strategies have unique risk-return characteristics that cause them to be categorized separately. Examples include life settlement investments, litigation finance, product finance, music royalties, art, and more.

The lifecycle of a fund typically lasts 7–15 years depending on strategy type, the macroeconomic environment, and idiosyncratic events.

Private markets funds are generally structured as drawdown funds, where a limited partner (the accredited and qualified investor) will make a binding commitment of capital that the general partner (GP) will call down as investments are identified during the fund's commitment period. A fund's commitment period typically lasts three to five years and may include distributions from income-producing assets or exited investments. Following the commitment period, GPs are generally more focused on the growth of the companies in their portfolios, and they begin to exit investments to return capital to limited partners. The entire lifecycle of a fund typically lasts 7–15 years, depending on strategy type, the macroeconomic environment, and idiosyncratic events.

Why one may want to consider investing in private markets

Capital continues to flow into private markets as investors look to create portfolios with compelling risk/return characteristics. For many investors, the factors that drive the decision to allocate to private markets are the opportunity for higher returns with potentially lower volatility and a lack of correlation with the other asset classes in their portfolios. Historical returns and annualized standard deviations (how much an investment fluctuates from its expected return) by asset class using 10 years of quarterly data from October 1, 2010 through September 30, 2020, are shown in Figure 3. Asset classes that approach the top left corner of the chart trend toward a higher return per unit of risk.

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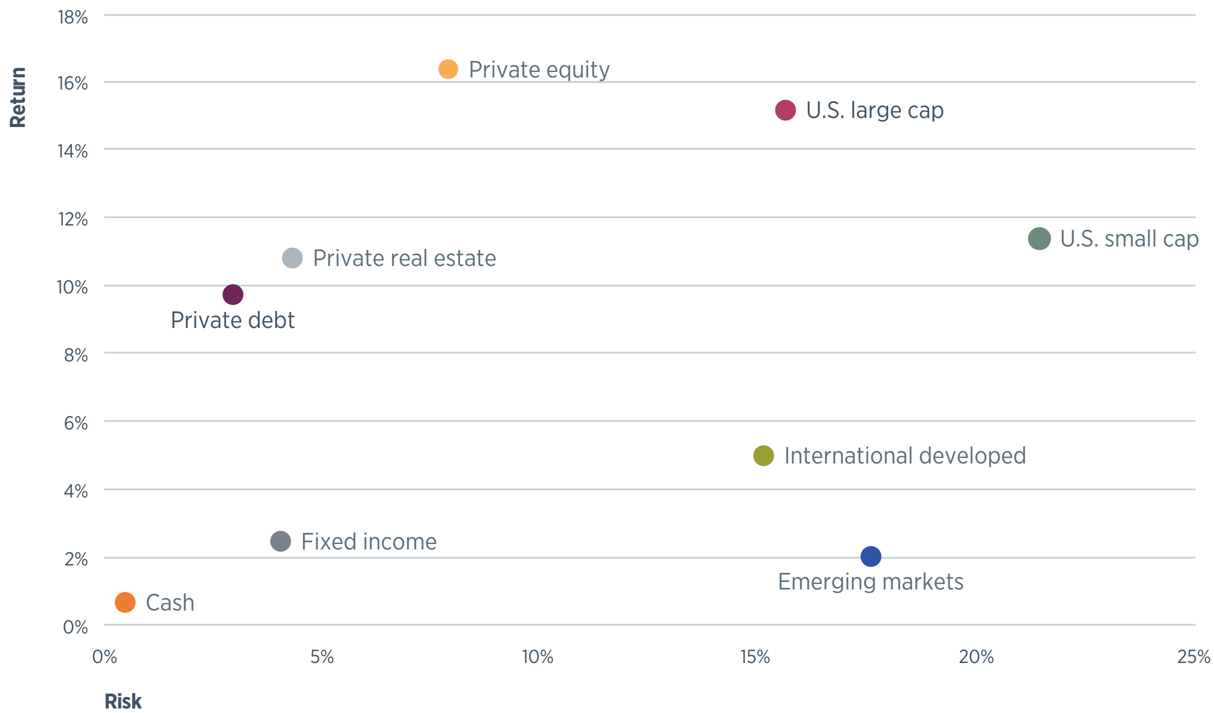
Figure 3

Asset class risk-return



Cash (Bloomberg Barclays Short Treasury Total Return Index Value Unhedged), Fixed Income (Bloomberg/Barclays US Aggregate Bond TR USD Index), U.S. Large Cap (Russell 1000 TR USD Index), U.S. Small Cap (Russell 2000 TR USD Index), International Developed (MSCI EAFE NR USD Index), and Emerging Markets (MSCI EM NR USD Index). Cliffwater Direct Lending Index (Private Debt). Cambridge Associates US Private Real Estate Index (Private Real Estate), and Cambridge Associates LLC US Private Equity Index (Private Equity).

Sources: Bloomberg, Cliffwater, Cambridge Associates (Copyright © IHS Markit. All rights reserved. See disclosures for important information regarding the Cambridge data.) and WTIA. Forecasts are derived from the expected return and volatility assumptions in Wilmington Trust's Capital Markets Forecast, which is available upon request from your investment advisor. Return and volatility projections are pre-tax and pre-fees. Data as of September 30, 2020.

Past performance cannot guarantee future results. Indices 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.

Private markets are generally less efficient with more opportunity for GPs to gain an informational advantage.

So how are private asset classes able to target higher returns? The ability of private markets managers to pursue higher returns compared with traditional managers lies in several key differences. A much larger and more diverse opportunity set of private companies and physical assets exists relative to those available in public companies. For example, while there are over 6,000[1] publicly listed stocks trading in the U.S., there are more than 700,000[2] U.S. firms that report having 20 or more employees.

The size of the investable universe combined with the limited availability of important information on private companies means private markets are generally less efficient. There is more opportunity for GPs to gain an informational advantage as a private business will typically disclose all of its financial records to potential buyers as part of the confidential due diligence process. Private markets funds are generally structured as long-term investment vehicles.

While a lack of liquidity can challenge some investors' comfort levels, it also means that much of the capital attracted to the space comes from investors comfortable with measuring the growth of their capital over 5–10 years or more. The management teams of private companies have the ability to take a long-term perspective, which may be more difficult for management teams susceptible to the quarter-to-quarter pressures of running a publicly traded company. What's

Continued

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

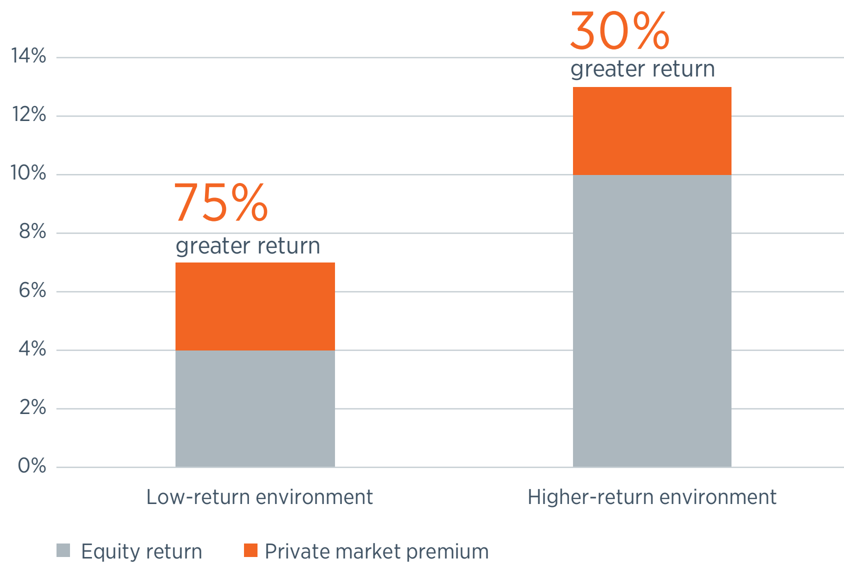
[2] https://www.naics.com/business-lists/counts-by-company-size/

The premium provided by private markets investments can be particularly impactful over periods with a muted return outlook.

more, GPs generally make significant investments in the funds they manage, often comprising 2% or more of total commitments, which would translate to GPs having a significant portion of their own net worth tied directly to the performance of the funds they manage. Performance alignment and long-term investment horizon alignment among limited partners, management teams, and general partners, often combined with the GPs having partial or total control, allows for the pursuit of more complex business strategies permitting major modifications and greater value creation potential.

Figure 4

Outperformance is more valuable in a low-return environment



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 low-return and high-return environments.

It is worth noting, the premium provided by private markets investments is particularly impactful over periods with a muted return outlook. Figure 4 illustrates how a potential 3% return premium is more impactful in a low-return environment.

Just as important as return premium is the diversifying return streams that private markets investments can bring to portfolios. Certain companies and assets not traded in public markets have differing risk premiums that drive their returns, providing the opportunity for return enhancement and/or volatility reduction at the portfolio level with low correlation to public companies and assets.

Using portfolio constraints along with return, volatility, and correlation assumptions, one can create an efficient frontier. A portfolio is considered efficient if it has the highest expected return for its level of risk. Take, for example, the two efficient frontiers plotted using Wilmington Trust's asset class projections, shown in Figure 5, detailing the effects of adding private markets exposure to portfolios. The respective volatility and returns associated with three of the most commonly assumed risk levels (conservative, balanced, and growth) are separately marked. Further, Figure 6 illustrates these portfolios' Sharpe ratios, which compares the average return of the portfolio to the level of volatility that return experienced along the way, with higher numbers indicating an improved risk-adjusted return.

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Figure 5
Efficient frontier

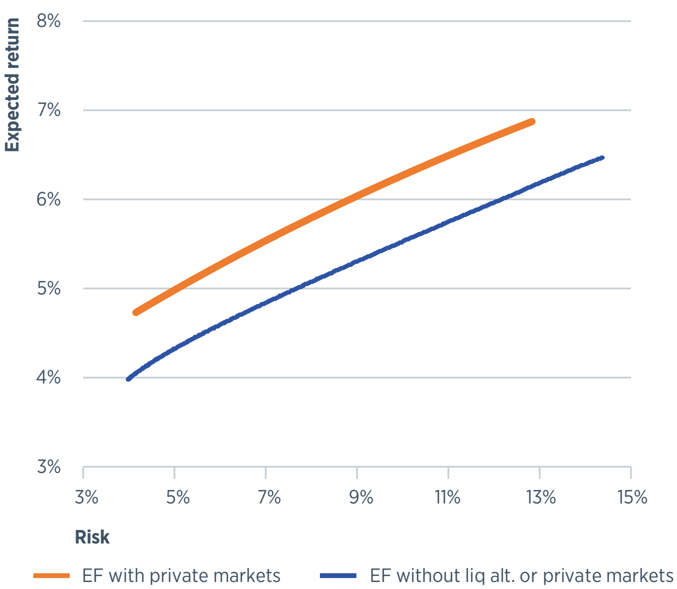
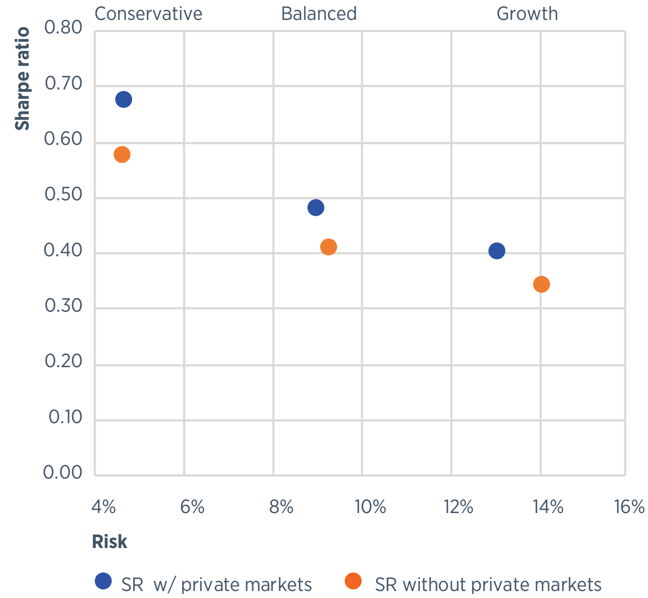


Figure 6
Sharpe ratios



Source: WTIA.

An optimal private markets allocation depends on an investor's unique investment profile; if he or she has near-term liquidity needs, exceeding a 20% allocation target may raise concerns.

At all three risk levels, the efficient frontier and Sharpe ratios for the portfolios with private markets investments are expected to outperform the corresponding portfolios without such exposure.

How much is too much—or not enough?

The optimal private markets allocations for investors depends on their unique investment profile; chiefly, their return objectives, risk tolerance, and liquidity needs. Typically, a range of 10% to 20% may be sensible for many investors, in our view, considering the illiquidity of private markets investments against the diversification benefits and potential for attractive, risk-adjusted returns.

For some investors with near-term liquidity needs, exceeding a 20% allocation target may begin to raise unacceptable liquidity concerns during extreme market scenarios such as the global financial crisis in 2008–2009. During this time, public market stocks declined over 50% and return of capital from earlier commitments to private markets ceased while capital calls from more recent commitments continued, putting pressure on portfolio-level liquidity and the ability to meet established spending goals.

However, for investors (often institutional) with large pools of capital, a sufficiently long-term investment horizon and limited liquidity needs, an appropriate allocation target may significantly exceed 20%. In fact, the 2019 National Association of College and University Business Officers (NACUBO) Endowment Study Series shows participating $1 billion+ endowments allocating more than 35% to a combination of private equity, venture capital, private debt, private real estate, and other private investments.

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Investors who too aggressively overcommit capital risk confronting liquidity pressures, which could force the sale of attractive positions they would otherwise choose to hold.

Conversely, investors with target allocations below 10% may fail to see a significant impact from private markets even if they select strong-performing investments due to their limited allocation size relative to their overall portfolios. What's more, some investors with particularly small allocations may fail to sufficiently offset the inconvenience and effort necessary to initiate and monitor ownership of private investments.

Regardless of target allocation size, after a long-term strategic asset allocation target is established, it can be challenging for investors to reach their desired level of investment. This is due to the uncertain nature of capital deployment and distributions as general partners call down capital over time and often begin distributions to limited partners during the investment period, which can offset capital calls. In order to reach an intended target, investors may need to overcommit to the asset class or risk deploying too little thereby limiting the ability of the asset class to fulfill its intended impact. Consider the idea that most investors with a diversified private markets portfolio rarely have more than two-thirds of their committed capital at work at any given time. If two-thirds of an investor's commitments are actually at work when the investor's capital is fully deployed, the investor would have to commit $15 million to private markets in order to achieve a $10 million strategic asset allocation target. At the same time, investors who too aggressively overcommit capital risk confronting liquidity pressures, which could limit their ability to meet commitments or force the sale of attractive positions they would otherwise choose to hold.

Building a diversified private markets portfolio can lead to more predictable cash flows at the portfolio level, relative to trying to predict the cash flows of any single private markets fund, and can therefore aid investors in developing a commitment strategy that is optimized to achieve their strategic asset allocation targets. Regardless, it is important for current and prospective private markets investors to continuously evaluate the composition and maturity of their programs. A new private markets investor may benefit from making outsized commitments in the early stages of building out the portfolio in an effort to frontload commitments and achieve their target exposure. Importantly, investors who have a more mature program and are looking to maintain their current allocations should determine the necessary pace of annual commitments in order to maintain the target allocation. Investors should factor in any large outstanding dollar amounts that have yet to be called from commitments made in prior years, which could require a slowed pace. The reverse would be true as well. This ongoing and iterative evaluation is a very important component of a successful program.

Efficient cash management

Investing in private markets typically involves making irrevocable commitments to investment vehicles with unpredictable cash outflows and cash inflows as well as illiquid underlying holdings. These characteristics make cash management in private markets inherently difficult and particularly important. Investors who take the time to understand and evaluate the possibilities available may be best positioned to maximize the potential benefits of investing in private markets.

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Private markets investments can be important contributors and diversifiers in a broader portfolio; however, any risks should be carefully evaluated prior to committing capital.

Investors should weigh the need to meet future capital calls from the managers to which they have committed against the need to maximize the return generation on assets as they are being held to fund obligations. Limited partners who miss a capital call generally face harsh penalties that should be strictly avoided. While keeping exorbitant amounts of capital tied up in cash for extended periods of time may seem like a safe option guaranteeing the ability to meet capital calls, this approach can lead to a large cash drag on performance as investors wait for their cash to be called and deployed into underlying investments.

As investors weigh these competing objectives with their advisors, it is important to understand that typically a single private markets fund will draw down capital over the first three to six years of its life and generally, the size of the capital calls decreases toward the end of this period. The pace of deployment will vary significantly among private markets fund managers.

Investors who can successfully build a private markets program over time may be able to achieve sufficient diversification by vintage year, strategy type, geography, and manager philosophy, such that the potential variation is reduced around expected capital calls and distributions at the program level. Effective cash management should consider an investor's entire private markets program, not just an individual fund, as well as overall target return goals and risk tolerance. Achieving diversification and greater predictability allows LPs to invest a relatively higher percentage of assets in public equities, with higher return potential and less in cash-equivalent securities that offer lower return potential.

A 2022 study by Neuberger Berman[3] suggests that, for investors with adequately diversified private markets portfolios, a carve-out liquidity portfolio requires only a 5% allocation to cash, with the remaining assets divided based on investor risk tolerance and market environment across public equity, fixed income, liquid alternatives, and uncorrelated diversifying assets. A similar study by PIMCO[4] found that holding capital earmarked for future capital calls in cash could eliminate almost one third of a 15% net internal rate of return* targeted by an average private equity fund. Instead, investors could tier capital commitments based on expected call timing across shorter-duration fixed income investments and higher-return public market equivalents to generate additional alpha (excess return vs. the benchmark index a security tracks) while maintaining relatively minimal shortfall risk.

Key risks of investing in private markets

Private markets investments can be important contributors and diversifiers in the context of a broader portfolio. However, investors should require a higher return target or return premium as compensation for the assumption of additional risks. Prior to committing capital to a private markets fund, the following risks need to be fully understood and carefully evaluated:

- **Limited liquidity** exists because the underlying assets held by private markets funds generally cannot be quickly and easily sold at full price. For this reason, general partners of private equity funds typically structure their funds as long-term investment vehicles, greatly limiting the ability of limited partners to redeem their investments at any given time. Investors generally look for an illiquidity premium in the form of a higher return target to compensate for the higher risk.

[3] https://www.nb.com/en/global/insights/whitepaper-integrated-liquidity-management-for-private-markets-programs

[4] https://se.pimco.com/en-se/insights/investment-strategies/featured-solutions/cash-for-calls-managing-liquidity-for-illiquid-investments/

*A metric used in financial analysis to estimate the profitability of potential investments, the internal rate of return is a discount rate that makes the net present value of all cash flows equal to zero in a discounted cash flow analysis.

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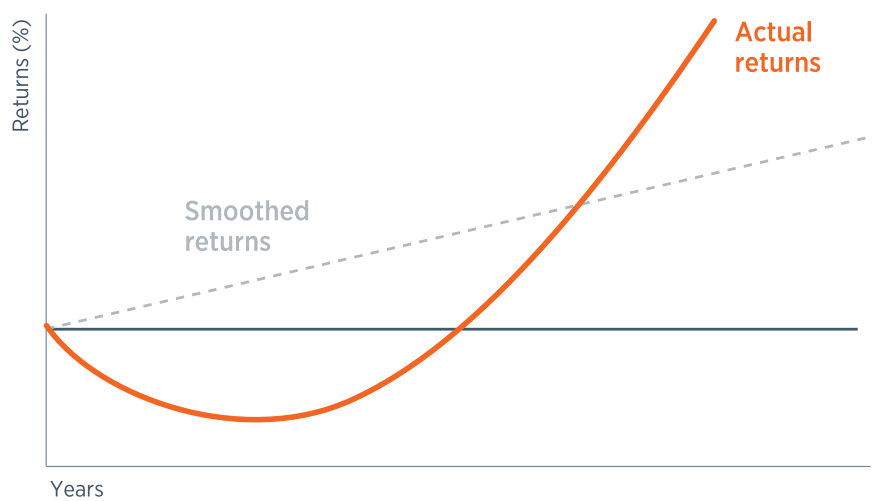
- **Operational risk** is the risk of loss from inadequate internal controls or processes and is particularly important in private markets because of the illiquidity of investments and limited regulation. Operational risk exists at both the general partner level, where it can be mitigated through effective manager due diligence, and at the underlying portfolio company level, where it can be mitigated by the general partner's due diligence.
- **Leverage** includes the use of additional debt by general partners to finance transactions. Leverage is commonly used by fund managers in private markets to increase returns and optimize the capital structure of their companies. However, the use of leverage also increases risk.
- **Less regulation and transparency** are the case with private funds. They are not subject to the same U.S. SEC registration as mutual funds and can instead rely on exemptions from such registration. What's more, investors have less transparency on underlying investments, generally committing capital to the fund prior to the fund having made any investments. These limitations make thorough due diligence particularly important when researching private markets opportunities.

Figure 7

The private equity performance J-curve



Source: WTIA.

This figure is for illustration purposes only and does not reflect the actual J-curve of any specific private market investment. The illustration is intended solely to depict the hypothetical J-curve of a typical private equity investment.

The J-curve

The J-curve can be used to illustrate the tendency of private equity funds to deliver negative returns in the early years, followed by investment gains as portfolio companies mature under the ownership and guidance of the GP and its operating partners. Before investing in private markets funds, it is important that the LPs' expectations are aligned with the strategy in which they are investing.

Continued

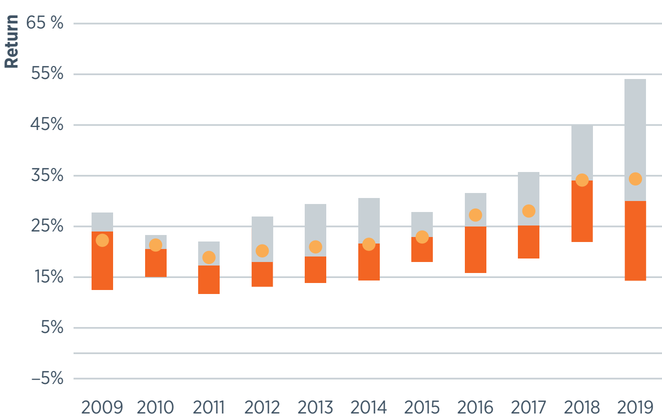
Several factors contribute to negative returns seen in the early stages of a private equity fund. Management fees and investment costs are both upfront expenses paid by investors as the GP is still investing fund capital long before the portfolio can generate excess returns. Once capital is fully deployed, the portfolio will consist of a number of portfolio companies selected by the GP. A poorly performing company may be identified early and written down, dragging performance in the beginning phases of the fund but preventing its underperformance from affecting fund returns later on.

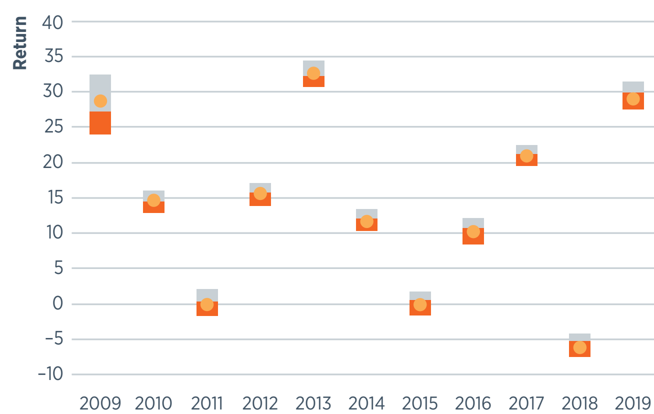
By design, many private markets teams purchase businesses they believe can improve and sell in the future at higher prices. Depending on the strategy employed, the initial performance of these companies will vary. Some firms work with growth companies well on their way to profitability, while others aim to capitalize on misunderstood companies or more complex situations, which may influence the depth of the fund's performance J-curve. Managers who create value through major operational transformations or strategic initiatives may have a deeper J-curve given the time it takes to implement and begin seeing the benefits of the improvements.

GPs know the J-curve can be a hurdle for potential private markets investors. It is increasingly common practice for GPs to have some investments identified during the fundraising period, which helps to mitigate the J-curve because it allows the GPs to put money to work quickly. This also provides potential investors with an opportunity to perform their own diligence on a portion of the underlying investments.

Figure 8

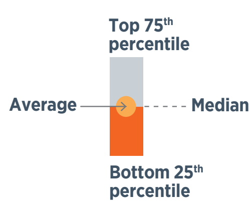
U.S. leveraged buyout and traditional large-cap equity managers





Source: Cambridge. Data as of September 30, 2020. Copyright © IHS Markit. All rights reserved. See disclosures for important information regarding the Cambridge data.

Past performance cannot guarantee future results.



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The importance of manager selection

Inefficiency and a lack of transparency in private markets as an asset class have led to wide dispersions in the returns of top-and bottom-performing managers. Looking at both charts in Figure 8, we can see that the spread between top-quartile and bottom-quartile U.S. fund managers for leveraged buyouts (the purchase of a controlling stake in a company, often through the use of a significant amount of debt) far exceeds the same dispersion or range metric for traditional public large-cap equity managers for vintage years 2009–2018. It is clear just how important it is to pick the right manager in private markets. Investors who selected top-quartile private equity managers have realized attractive returns well above the median.

Beyond investing in managers who have the potential to generate outsized returns, rigorous research on managers can help mitigate some of the aforementioned risks through deep investment and operational due diligence.

Conclusion

For many investors, private markets may represent an attractive investment opportunity at both the asset class and the portfolio levels, given the impact an allocation to the space can have on the risk-reward characteristics of the overall investment portfolio. It is important to understand the expected characteristics of an individual private markets fund. Is the manager focused on private equity, private debt, or something else? How large are the companies in which they make investments, and is the manager taking controlling stakes? In which industries and regions do the target companies generally operate? Answering these questions can help establish baseline expectations for a given fund, including a range of potential return outcomes, how deep or nonexistent the J-curve may be, and many other important considerations.

A successful private markets program can provide portfolios with a return premium above public equities for a reasonable amount of risk and with a low correlation to other portfolio asset classes. We encourage you to have this discussion with your investment advisor who can take a careful, holistic look at your unique circumstances and all of the relevant factors to assess whether private markets might be a smart enhancement to your portfolio.

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DEFINITIONS

Bloomberg Short Treasury Total Return Index Value Unhedged measures the performance of the US Treasury bills, notes, and bonds under 1 year to maturity.

Bloomberg U.S. Aggregate Index, formerly known as Lehman Brothers U.S. Aggregate Index, measures the performance of the entire U.S. market of taxable, fixed-rate, investment-grade bonds. Each issue in the index has at least one year left until maturity and an outstanding par value of at least $250 million. The index includes the Barclays Capital U.S. Government/Credit, U.S. Mortgage-Backed Securities, and U.S. Asset-Backed Securities indices.

Cliffwater Direct Lending Index (CDLI) is an index comprising all underlying assets held by public and private Business Development Companies that satisfy certain eligibility requirements. The index is asset-weighted by reported fair value.

Cambridge Associates LLC US Private Equity Index® is 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.

Cambridge Associates US Private Real Estate Index is a horizon calculation based on data compiled from 1,021 real estate funds (including opportunistic and value-added real estate funds), including fully liquidated partnerships, formed between 1986 and 2017. 1 Pooled horizon return, net of fees, expenses, and carried interest.

Russell 1000® Index measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 92% of the total market capitalization of the Russell 3000 Index.
As of its latest reconstitution, the index had a total market capitalization range of approximately $1.3 billion to $309 billion.

Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. As of its latest reconstitution, the index had a total market capitalization range of approximately $128 million to $1.3 billion.

MSCI EAFE® (net) Index measures the performance of approximately 20 developed equity markets, excluding those of the United States and Canada. The total returns of the index are net of the maximum tax withholding rates that apply in many countries to dividends paid to non-resident investors.

MSCI Emerging Markets (net) Index measures the performance of approximately 25 developing equity markets. The total returns of the index are net of the maximum tax withholding rates that apply in many countries to dividends paid to non-resident investors.