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Elston Insights

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Private markets: is it worth the risks?

- Good in theory, problematic in practice
- Advantages and disadvantages
- Changing market regime

Introduction

There is an investment case for investing in private markets, and the asset class has proved popular with institutional investors, including those with long-term time horizons and high liquidity tolerance – such as endowments. But not every endowment has enjoyed the success of the early adopters under the "Swensen model".

A private market allocation is structurally hard to reverse if things go wrong with any of 1) the investor's liquidity needs, 2) the private market fund's underlying investments, or 3) the realised returns relative to risk-free investments (e.g. gilts) for a given term.

As such, an allocation to private markets should be seen more like an irreversible decision, unlike almost all other investments available to institutional investors which can be sold at a day, week or month's notice.

In this brief note, we do not set out the case for investing in private markets – that has been set out extensively elsewhere. We do however raise some points of challenge to those stated advantages.

Good in theory, problematic in practice

Whilst there are good reasons in theory why an allocation to private markets makes sense, the operational and practical aspects of making a private market investment via a private market fund structure raise additional non-investment risks that should also be considered.

Some strong arguments challenging investments in private markets have been set out in Professor Andrew Ang's[1] book on asset management[2]. Chapter 13 (Illiquid Assets) and Chapter 18 (Private Equity), and some key points are cited where applicable below.

Ang's key points on Illiquid Assets[3] are summarised below

- Reported returns for illiquid asset classes are "too good to be true" owing to overstatements arising from survivorship bias, infrequent valuation and selection bias.
- Illiquidity premium: Ang argues that the best way to harvest illiquidity premium is through rebalances of liquid portfolios (providing liquidity to those investments), rather than holding illiquid assets, less liquid assets or market-making.

Ang's key points on Private Equity[4] (and those below also apply to private markets) are summarised below

On the whole private equity does not outperform publicly traded stocks on a risk-adjusted basis.

- Transcation costs are high – particularly in times of distress: Harvard University faced discounts of 50% of NAV to exist certain PE funds during the financial crisis.
- Unlike public markets, valuation is difficult, subjective and available infrequently.
- Investment and disinvestment is complex and restrictive.
- Private equity contracts are complex and exacerbate rather than improve agency problems (conflicts of interest).

Advantages and Disadvantages

The Pros & Cons of investing in private markets via a private markets fund are set out below.

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[1] Andrew Ang is the Ann F. Kaplan Professor of Business at Columbia Business School. He is a financial economist whose work centers on understanding the nature of risk and return in asset prices. His work spans municipal and government bond markets, equities, asset management and portfolio allocation, and alternative investments. Prof. Ang graduated in 1999 with a PhD in Finance from Stanford University and joined Columbia University in that year. He is a Research Associate of the National Bureau of Research serves as adviser to several asset managers, including the Norwegian sovereign wealth fund.

[2] Professor Andrew Ang, *Asset Management: A Systematic Approach to Factor Investing* (2014).

[3] Ang, ibid, chapter 13

[4] Ang, ibid, chapter 18

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Fig.1. Pros & Cons of a private market investment

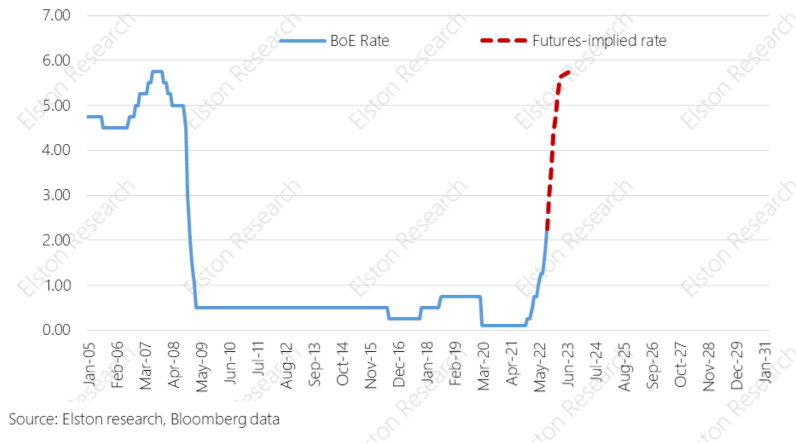
	Pros	Cons
Return target	Helps to enhance returns	Similar returns are available via public market without the illiquidity problem and complexity issues.
Historic returns	Show a premium to public market equivalent	This never reflects the full universe, as these are subject to survivorship bias (which funds are still around), also reporting bias (data of which funds is submitted for evaluation)[5]
Diversification	Private markets is a diversifier from existing return drivers, as part of a broader allocation	There are other, liquid and lower cost ways of achieving risk-based or asset-based diversification.
Risk & Correlation	Risk (volatility) and correlation of private markets enables diversification	Reported riskiness (volatility) of a fund of funds, and of the underlying funds is under-stated owing to the concept of "infrequent trading". Like property funds, valuations of underlying assets assessed perhaps quarterly (compared to every waking second for public markets). This leads to an understatement of volatility.[6]
Sectors	Access to alternative asset classes in addition to property. This means focus on private debt, infrastructure and impact/sustainable.	Listed alternatives exist for property an infrastructure. Private debt may have been more attractive in a near-zero interest rate environment (2008-21), but that regime is now over.
Access	Use of a private market fund vehicle enables a convenient structure to access the asset class.	The fund requires a long-term commitment and is hard to reverse.
Whole of market	A private market fund of funds vehicle provides a broad range of funds, harnessing other clients' scale.	The additional layer of fees adds to complexity and a further drag on returns.
Illiquidity premium	Private markets provide an illiquidity premium to public markets	This may be for certain vintages of funds, during certain market regimes, but is not necessarily the case once the operational aspects of investing in private markets is considered.
Transparency	Private Markets provide superior returns	IRRs are not return comparables. Public Market Equivalent benchmarks should be compared to sector-based not overall market-based benchmarks.
Flexibility	A private market fund of funds has access to a range of sub-funds.	Investing via a private markets fund is a long-term commitment.

[5] Ang, ibid, p.416 Illiquid Asset Reported Returns Are Not Returns
[6] **Ang, ibid, p.418 Illiquid Asset Reported Returns Are Not Returns**

Change in market regime

The post-financial crisis era of near-zero interest rate policy and QE is over as Central Banks try and get ahead of supply-side inflation. The chart below shows the end of the easy money era plotting BoE Bank Rates. A look at market implied UK policy rates suggests there is more tightening to come. Quantitative Tightening also means systematic withdrawal of liquidity that previously flooded all asset class.

Fig.2. BoE Bank Rate and market-implied policy rates, as at end September 2022

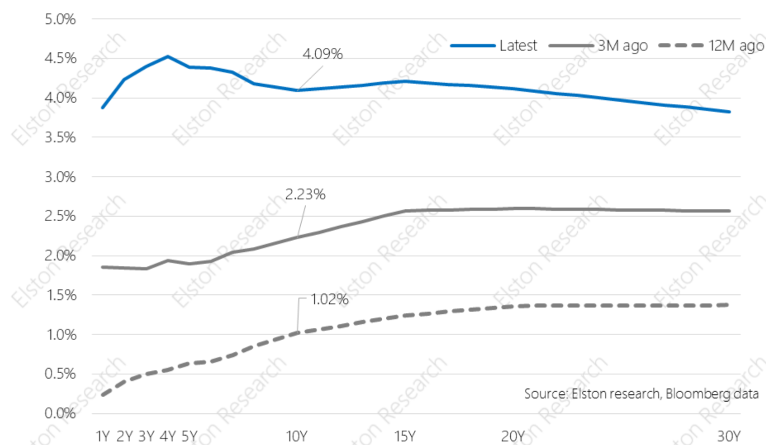


Data as at September 2022

The other change in market regime is that "yield is back". If investors can buy gilts (lend to the government) for 2 years with a ~4.5% return, and earn 1-2% additional return if buying short-dated corporate bonds, then the hurdle rates for illiquid debt have just increased.

The dramatic increase in the risk-free rate forces raises the hurdle rate for private markets, and increases the opportunity cost of investing in a liquid and transparent alternative to private markets.

Fig.3. UK risk-free (gilts) yield curve is back – even at the short-end, as at end September 2022



Cash calls

Cash calls from private market funds can come at inconvenient times. Careful liquidity risk planning is required to ensure planned commitments are provisioned and funded. Careful understanding of a private market fund's Terms & Conditions as required unplanned cash calls is required to ensure there is no risk that there will be other unplanned cash calls other than those planned commitments.

Cash calls from private market funds are at present triggering their own mini-doom loop of forcing investors to sell other liquid public market holdings at depressed levels to meet their capital commitments to private market funds. Bouts of market illiquidity – which can create systemic risks for public markets are even more acute for private markets.

Fig.4. Capital calls from private market funds

Capital Calls

Investors are sending more money into private-market funds than they are getting back

Private Fund Type	Distribution ($ billions)	Contribution ($ billions)	Net ($ billions)
Buyout	26.75	34.4	-7.66
Distressed	1.48	3.8	-2.28
Natural Resources	3	0.9	2.11
Real Estate	6.28	8.4	-2.09
Senior	2.13	4.1	-2.01
Venture Capital	2.43	7.5	-5.01

Source: The Burgiss Group, Bloomberg.
Data provided as of Sept. 30, 2022.

Summary

For institutional investors, allocations to private market fund-of-funds may not provide good value for money for the following reasons:

- Returns: The returns available from private markets are as uncertain as they are for public markets. However by using a private markets fund of funds, the higher and layered fees are a certainty.
- Volatility: the volatility of a private market fund is understated, whilst this helps with volatility modelling, it masks underlying actual economic risks. (The same under-statement exists between property funds and listed property securities.)
- Illiquidity: not only is the receipt of an illiquidity premium unlikely for the average private market investor, liquidity commitments can create a negative doom-loop in unlucky times when those cash calls come when liquidity is at its most scarce. The recent Bloomberg

article illustrates the same point. Pension schemes recently had a similar experience through LDI margin calls.

- **Market regime:** achieving a 5-6% yield in a near-zero interest rate policy environment was unthinkable 2008-2021. In part this drove flows into private markets to seek return. Now you ~4-5% yield on a <5 year gilt, and 5-6% on <5 year corporate bond, for fees below 0.10% and intraday liquidity. Why bother making return seeking more complicated, now that yield is back?
- **Diversification:** there are lower cost, and more liquid ways to achieve "true" diversification (incorporation of decorrelated asset classes) such as absolute return funds, uncorrelated assets and dynamic asset allocation strategies.
- **Complexity & inflexibility:** an allocation to private markets introduces additional complexity as regards evaluation, valuation frequency, capital commitments and requirement for liquidity risk management. The inherent inflexibility (inability to disinvest, and requirement to invest further) puts a material constraint on investors unlike all other capital market investments.
- **Conflict of interest:** as well as agency frictions inherent within private market funds, there is a broader agency friction and conflict of interest using a fund of fund structure. Whilst insistence on product fee disclosure helps size and monitor this conflict of interest, it does not mitigate it.
- **Outcome:** the performance outcome of the investment – relative to public market equivalents is uncertain, and will be hard to evaluate. The higher, opaque and layered fees are, however, a certainty.

Conclusion

It is right that institutional investors should consider the private markets opportunity as an investment case.

But often, there can be scope for greater potential value add if decision-makers use that time to consider broader asset allocation and fund selection decisions in a changing market regime and implement those decisions in a timely manner.

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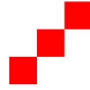

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