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Private market investments

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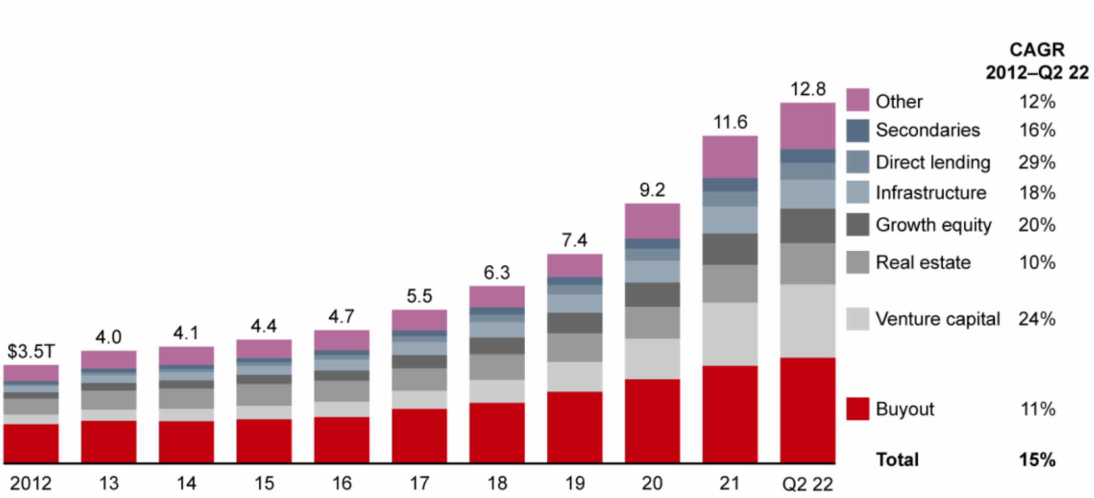
I have a friend, Jake, who runs a convenience store on the street corner. Before becoming a store owner, Jake worked as a firefighter. He invested US$ 200,000 of his savings to rent the store, decorate it and hire a few employees. I gave him a US$ 50,000 loan for inventory.

Starting businesses by raising capital from family and friends has always been common practice. The world of private market investments is no different, except it encompasses a broader network of investors beyond personal connections.

> In the past, private market investments fell into the 'alternative investments' category, along with hedge funds, commodities, and other similar assets. As the name suggests, these were not conventional or mainstream. However, over the past decade, private market investments have become mainstream among institutional and individual investors.

Figure 1 illustrates the breakdown of assets under management (AUM) for private market investments by asset type. Since 2012, private market AUM has shown a CAGR of 15% across a broad array of underlying investment strategies, with the most notable being growth equity, venture capital and direct lending with CAGRs of 20%, 24% and 29%, respectively.

Figure 1
Global private markets AUM by asset type (in US$ trillion)



Note: *"Buyout" includes buyouts, balanced, co-investment, and co-investment multimanager funds. "Other" includes fund-of-funds, mezzanine, natural resources, hybrid, private investment in public equity and real assets.*
Source: *Bain & Company, Preqin, February 2023*

What are private market investments?

Public markets are easy to comprehend and define. In these markets, companies sell shares and bonds to the general public, and investors can typically trade these securities on exchanges or other avenues, making them 'public market investments'.

On the other hand, private market investments are less straightforward. Investors unfamiliar with various types of private market investments might be overwhelmed by the diverse asset classes listed in Figure 1. What is more confusing is that often institutions and investors have their own labelling and definitions, which may differ from the graph's legends.

In our view, regardless of the naming conventions, private market investments fall into two primary groups: **private equity** and **private credit**.

Using Figure 1 as an example, private equity includes buyouts, venture capital, growth equity and parts of private real estate, infrastructure, secondaries, and so forth. Private credit includes direct lending and parts of private real estate, infrastructure, secondaries, and so forth. For example, a category like real estate is usually listed as a separate asset class. However, there are only two types of investments in private real estate projects: equity or debt. The same principle applies to infrastructure and other real assets. Therefore, we use the broadly defined private equity and private credit to cover private market investments. It is worth noting that private equity funds exclusively refer to buyout funds in certain markets, but our interpretation is more inclusive.

Whether you are scrolling through TikTok or using ChatGPT, you are engaging with services and products offered by companies backed by private equity and private credit investments. For instance, Jake's invested savings represent private equity investments, while my loan constitutes a private credit investment.

The supply and demand of capital

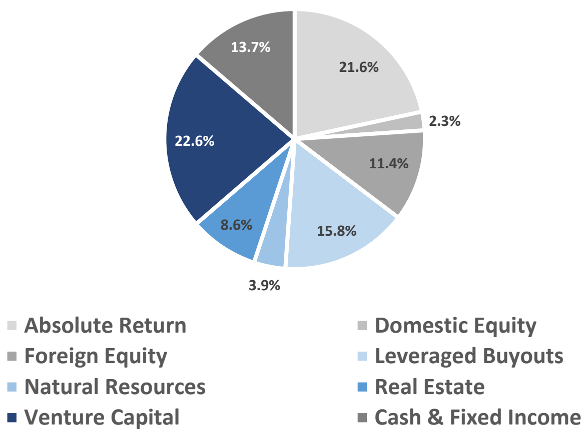
The evolution of supply and demand for capital has primarily driven the surge in private market investments. Academic research and investment practices partially fueled this transformation.

Yale Model

An approach to asset allocation that emphasises large allocations to non-traditional investments (see Figure 2), including equity-oriented investments driven by investment manager skill (e.g., private equity), is commonly referred to as the Endowment Model or Yale Model. The term Yale Model originated from the Yale University Investments Office, led by David Swensen, who pioneered this approach during the 1990s. The Endowment Model reflects the influence of this approach on various US university endowments. Swensen's practices were based on principles developed by Yale economists, primarily Nobel laureates Harry Markowitz and James Tobin, whose works Swensen had studied closely.

Figure 2

Portfolio allocation of the Yale Endowment as of 30 June 2020



Note: *The blue shades are all private market investments, while the grey shades are public market investments*

Source: *The Yale Endowment 2021 Report*

The "modern portfolio theory", developed by Markowitz in the 1950s, aimed to design an ideal investment portfolio that would yield maximum returns by assuming optimal degrees of risk based on the discipline of mean-variance analysis. Tobin affirmed that asset allocation, rather than market timing or individual security selection, is "the single most important investment decision" and accounts for over 90% of the variance in institutional fund performance outcomes. The teachings of Markowitz and Tobin showed the weakness of the traditional portfolio composed of 40% public bonds and 60% public equity.

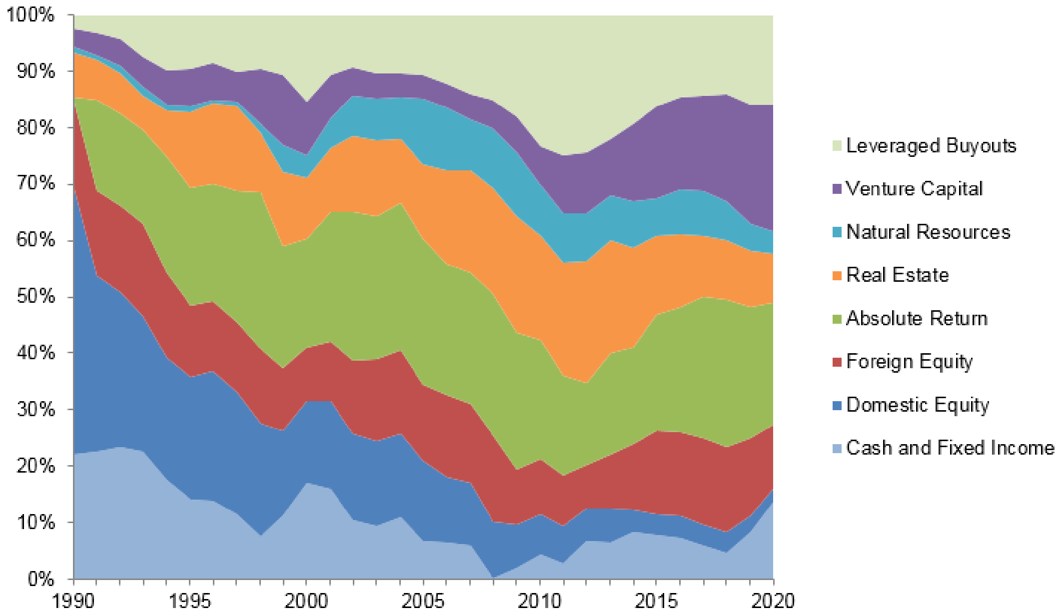
The Yale Model depends on meticulous attention to risk analysis and the shifting proportions of individual asset classes within the endowment investment portfolio. These proportions change over time depending on market factors and institutional requirements (see Figure 3).

Yale's strategy relies on equity investments, broadly defined. Over 60% of the portfolio comprises global equities and illiquid asset classes like leveraged buyouts, venture capital, real estate, and natural resources - 'inefficient' asset classes in which active management can add significant value.

Besides high allocations to non-traditional assets, this approach characteristically seeks to earn illiquidity premiums, which endowments with long time horizons are well positioned to capture. Private equity and private credit offer exactly that illiquidity premium.

Figure 3

Evolution of the Yale Endowment portfolio over 30 years



Source: https://investments.yale.edu/

Canada Model

Over the past decades, a growing body of literature has shed light on the distinctive features characterising Canada's large public pension funds, often called the Canada Model.

The research: "*The Canadian Pension Fund Model: A Quantitative Portrait"* shows that, between 2004 and 2018, large Canadian funds outperformed their peers on all fronts. The authors attribute the success of the Canada Model to three key features, one of which involves allocating assets that increase portfolio efficiency and hedge against liability risks, including real estate and infrastructure.

Furthermore, the allocation to private market investments is supported by the belief that they offer superior risk-adjusted returns. The same research conducted regressions spanning 15-years to analyse the drivers of performance under the Canada Model. It was found that increases in allocation to private equity and private credit lead to better risk-adjusted returns, as evidenced in the improvement in the portfolio's asset Sharpe ratio, compared to allocations to stocks and fixed income, respectively (see Table 1).

Table 1

Drivers of large Canadian pension funds' return and hedging performance based on regressions (2004 – 2018)

	Asset Sharpe Ratio		
	coefficient	**standard error**	**p-value**
% in Stocks	0.66	0.10	0.00
% in Fixed Income	1.15	0.12	0.00
% in Real Assets	1.30	0.26	0.00
% in Hedge Funds	0.63	0.18	0.00
% in Private Equity	0.70	0.34	0.04
% in Private Credit	1.82	0.84	0.04

Source: *Beath, A., Betermier, S., Flynn C., and Spehner Q., The Canadian Pension Fund Model: A Quantitative Portrait*

Both the Yale Model and the Canada Model influenced institutional investors worldwide by encouraging them to increase their allocation to private market investments, which boosts the supply of capital to private markets.

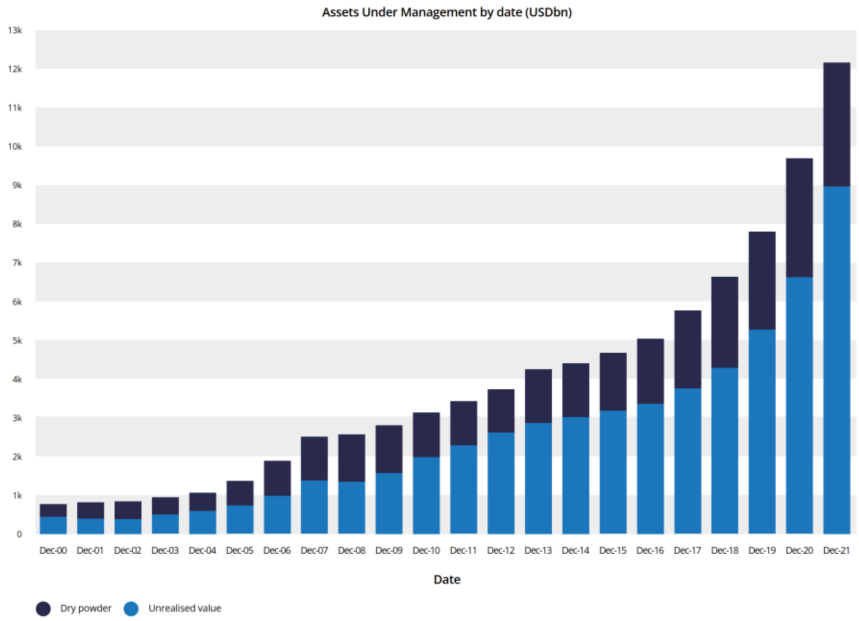
There have been changes on the demand side, too. In the past, selling shares to the public was an important way for companies to raise capital. That is no longer the case with companies like Uber and Airbnb attracting substantial investments while remaining private. In addition, some large companies have gone private with the help and capital from private market investors, including Dell, Arm and Twitter, although some went public again after reshaping themselves during their 'private' periods.

As mentioned earlier, the demand for private capital has increased. According to McKinsey, private equity deals reached $2.4 trillion in 2022, with nearly 60,000 transactions. Some of these transactions have become so substantial that even institutional investors find them too sizeable to tackle.

A similar story is true with private credit, although this time, the driving force is predominantly regulation rather than voluntary decisions. Commercial banks have been under increasing pressure since the Global Financial Crisis in 2007/2008, due to regulations like Basel III and the Dodd-Frank Act. This pressure has compelled banks to veer away from 'risky investments', leading to a loss of market share to non-bank financial institutions and private credit funds. These funds have quickly amassed tremendous AUM in a matter of years (see Figure 5). As a result, credit demand from both individuals and corporates is now often met with Private Credit.

Figure 5

Global private credit AUM



Source: *Financing the Economy 2022, Preqin*

How do you invest in private markets?

Historically, only institutional investors and high-net-worth individuals could invest in private markets. Certain large institutional investors favour taking up private market investment through direct transactions. For example, in 2021, the Canada Pension Plan Investment Board (CPPIB) bought marine terminal operator Ports America from Oaktree Capital Management LP for an undisclosed amount. According to public sources, Oaktree valued Ports America at $6 billion.

Co-mingled funds have become the most common avenue for investors to access private market investments. Most of these funds are closed-end, with long investment horizons, although many are also open-end funds. Additionally, managers of private market investments are familiar with setting up co-investment vehicles or other special purpose vehicles (SPVs) to cater to large investors' specific needs. Private placement of loan notes or stakes in SPVs is also often seen in the credit space.

Private market investments are no longer exclusive to large institutional investors only.

In Michael W. Azlen and Ilan Zermati's (2017) research paper titled: *"Investing Like the Harvard and Yale Endowment Funds",* adopting similar asset allocation principles allows smaller investors to achieve high levels of risk-adjusted returns in their portfolios, with returns that often surpass those traditional equity/bond portfolios and most balanced investment funds.

Some co-mingled funds are offered in structures that permit investments for as low as EUR 100,000, such as the Reserved Alternative Investment Fund (RAIF) vehicle, an unregulated Luxembourg collective investment scheme. These low-threshold funds offer easier access to private market investments for high-net-worth individuals and family offices. In addition to the funds, investors in certain jurisdictions can access private market investments through publicly listed structures such as business development companies

(BDCs), which are closed-end investment vehicles organised by the Investment Company Act of 1940 in the US.

In conclusion, over the past few decades, private capital markets have evolved into a much deeper and more sophisticated market which has attracted a diverse investor base, ranging from institutional investors to family offices and, in some instances, retail investors. It comes as no surprise that this asset class has experienced a significant uptick in investor demand, given the attractive risk-adjusted, return-enhancing characteristics of private capital investments (which are underpinned by the liquidity premium earned on these investments) coupled with this asset class becoming increasingly accessible to more investors via various investment vehicle structures.

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Glacier Research would like to thank Theodore Qi Shou for his contribution to this week's *Funds on Friday*

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Theo joined Skybound Capital in 2011 and acts as its Chief Investment Officer. With a background in academia in China, Theo started his finance career at HSBC, where he was mostly involved in manager selection and portfolio construction. Theo holds Masters' and Bachelor's degrees in Economics and is both a CFA® and a CAIA charter holder.