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Navigating private markets: understanding the dynamics of private equity and private credit investing

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In an era marked by market volatility and shifting economic landscapes, private market investments have become vital components of a well-diversified portfolio. Investors are increasingly turning to these markets for returns that show lower correlation with traditional asset classes, while still offering attractive performance potential. However, a clear understanding of the distinct characteristics and dynamics of Private Equity (“PE”) and Private Credit (“PC”) is crucial for effective portfolio construction and prudent risk management.

Private Equity vs. Private Credit: core differences

PE and PC, while both private market assets, differ fundamentally in their objectives, strategies, and risk-return profiles.

PE involves acquiring significant or controlling stakes in privately held companies, with the goal of enhancing their value through strategic, operational, and financial improvements. Common PE strategies include leveraged buyouts, growth capital, venture capital, and distressed investing. PE investors often work closely with management teams, influencing strategic decisions and driving operational improvements to maximise value.

PC, in contrast, focuses on providing direct loans to businesses outside of the traditional banking system. These loans may take the form of senior secured debt, mezzanine financing, or structured credit solutions. PC prioritises predictable cash flow, capital stability, and preservation. PC investors seek steady income through interest payments rather than aggressively pursuing capital appreciation.

Differing philosophies: Growth ambitions vs capital preservation

PE is growth oriented. PE Funds aim to generate substantial returns by targeting companies with high growth potential. Typically, a small subset of standout companies in a PE portfolio drives the bulk of the overall return. Investors accept elevated levels of idiosyncratic and systematic risk in pursuit of exponential returns, recognising that the difference between top- and bottom-quartile outcomes can be material.

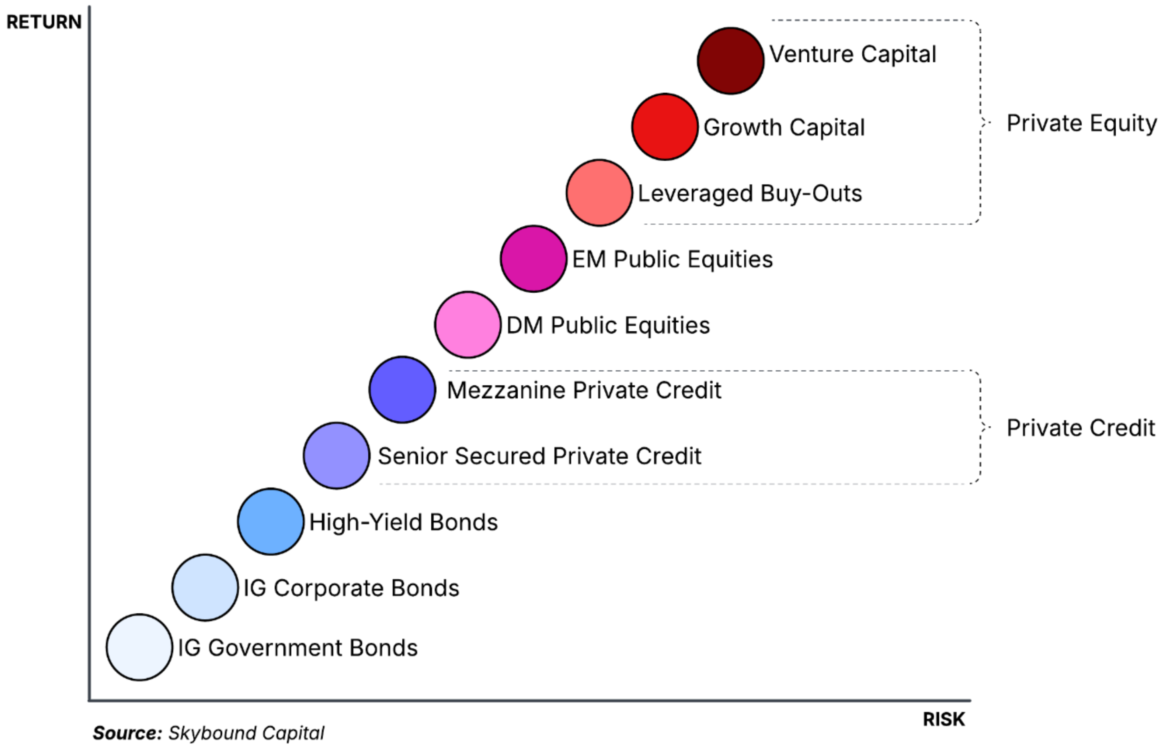
PC, conversely, is philosophically grounded in capital preservation and the reliable delivery of periodic income. As Benjamin Graham and David Dodd's noted in Securities Analysis, fixed income investing may best be conceptualised as a "negative art", focused on avoiding losses rather than the pursuit of outsize gains. PC investors rely on meticulous risk assessment and careful loan structuring aimed at downside protection. Returns are generally fixed and predictable, reflecting disciplined underwriting and risk mitigation practices, making PC inherently more stable.

Balancing risk and return in portfolio management:

From a portfolio management perspective, how do these assets correspond with considerations of risk and return? While the Figure referenced provides a simplified illustration of the intricate relationships among the risk-return profiles of various assets, it still helps position PE and PC within a traditional framework.

Figure 1

Risk vs Return | Comparison to Traditional Assets



Source: *Skybound Capital*

Figure 1

The risk of loss is not always obvious when evaluating PE or PC performance.

Figure 2

Asset Class Annual Return Comparison

Discrete Annual Returns	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	Cumulative
Preqin Private Equity Index	**-21%**	**8%**	**19%**	**9%**	**14%**	**18%**	**14%**	**11%**	**10%**	**19%**	**12%**	**16%**	**23%**	**41%**	**-2%**	**6%**	**7%**	**520%**
US Equities	-37%	26%	15%	2%	16%	32%	14%	1%	12%	22%	-4%	31%	18%	29%	-18%	26%	25%	**460%**
Preqin Private Debt Index	**-21%**	**22%**	**16%**	**4%**	**17%**	**16%**	**8%**	**4%**	**8%**	**13%**	**6%**	**8%**	**4%**	**20%**	**4%**	**9%**	**8%**	**286%**
Global Equities	-40%	31%	12%	-5%	17%	27%	6%	0%	8%	23%	-8%	28%	16%	22%	-18%	24%	19%	**255%**
EM Equities	-53%	79%	19%	-18%	19%	-2%	-2%	-15%	12%	38%	-14%	19%	19%	-2%	-20%	10%	8%	**38%**
Global HY Bonds	-27%	59%	15%	3%	20%	7%	0%	-3%	14%	10%	-4%	13%	7%	1%	-13%	14%	9%	**176%**
US IG Corporate Bonds	-5%	19%	9%	8%	10%	-2%	7%	-1%	6%	6%	-3%	15%	10%	-1%	-16%	9%	2%	**96%**
Global IG Government Bonds	10%	3%	6%	6%	2%	-4%	-1%	-3%	2%	7%	0%	6%	9%	-7%	-17%	4%	-4%	**16%**

Note: Asset class returns have been represented by an index. US Equities = S&P500 Index ; Global Equities = MSCI World Index ; EM Equities = MSCI EM Equities Index ; Global HY Bonds = Bloomberg Global High-Yield Index ; US IG Corporate Bonds = Bloomberg US Corporate Bond Index ; Global IG Government Bonds = Bloomberg Global Treasury Index

Figure 2

Source: *S&P Capital IQ, Bloomberg*

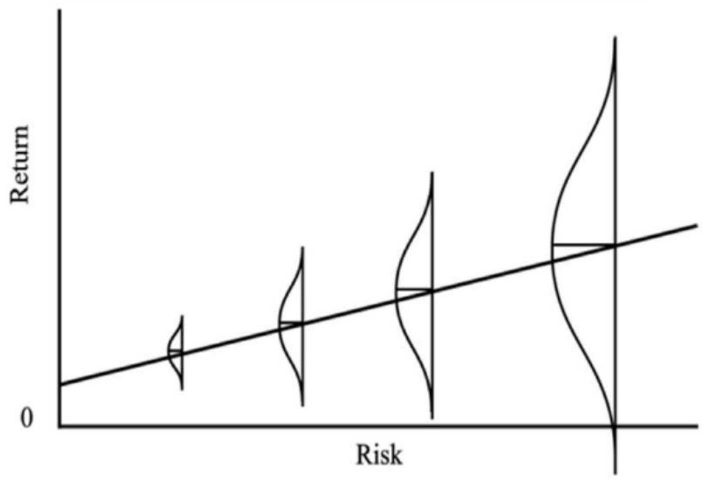
The table *(Figure 2)* provides a year-on-year return comparison of Private Debt and Equity versus traditional assets. On face value, the overall return outcome is as expected, with Private Equity outperforming global equities over time, while PC/PD delivers equity-like returns with lower volatility and a premium over fixed income markets. What is important to note, however, is that while PC's annual returns may appear less competitive on a year-by-year basis; over the long term, the benefits are more evident.

Returns variability in private markets:

What the risk-reward graph *(Figure 1)* fails to show is the variability inherent in investment returns. As Howard Marks observed in his 2014 paper *'Risk Revisited'*, "if riskier investments could be counted on to produce higher returns, they wouldn't be riskier." This insight underscores the necessity of carefully evaluating investment risk as a fundamental aspect of risk management. Marks' risk spectrum chart *(Figure 3)* effectively illustrates the range of possible outcomes beyond the simplistic risk-reward model.

Figure 3

Risk vs Return | Howard Marks - Risk Revisited



Source: *Oaktree Captial Management*

Figure 3

Why is this important? It highlights that, despite the attractive potential for substantial returns associated with PE relative to PC, investors must also acknowledge the equally significant risk of substantial losses.

While the private market indices illustrate overall return trends, they do not reflect the variability in outcomes or the degree of return dispersion. This is where a deeper discussion of risk becomes essential.

Figures 4 and 5 show the distribution of fund manager net IRRs (%) from 2013 to 2022 for PE and PC. Although median returns for both asset classes appear relatively stable, the spread between top and bottom quartile managers in PE is substantially wider than in PC. This significant dispersion highlights the critical importance of rigorous manager selection and thorough due diligence when making an allocation to PE.

Figures 4 & 5

Private Equity Fund IRRs (%) | 2013 - 2022

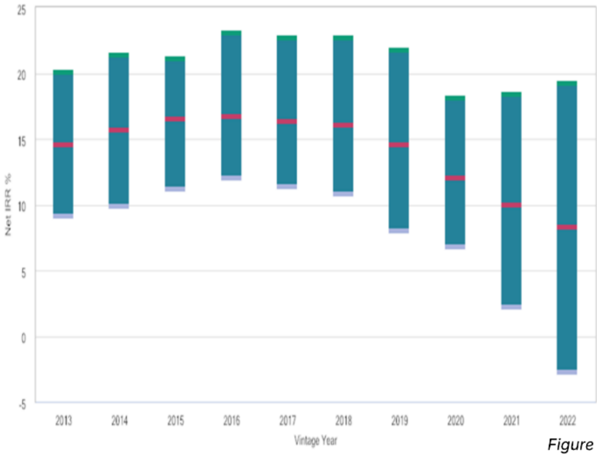


Figure 4

Private Credit Fund IRRs (%) | 2013 - 2022

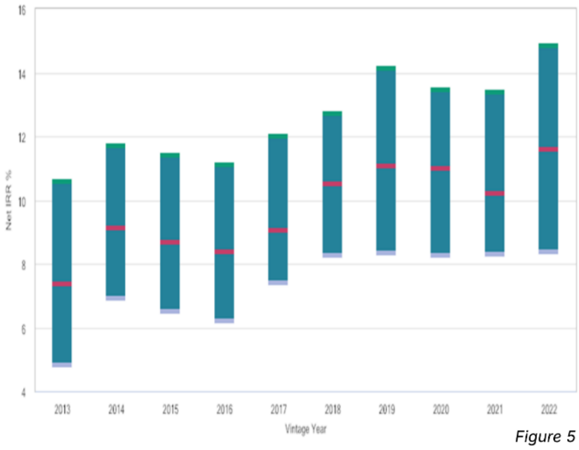


Figure 5

Bottom Quartile Boundary To Top Quartile Boundary — Top Quartile Boundary — Median — Bottom Quartile Boundary

***Source**: S&P Capital IQ*

Integration of Private Equity and Private Credit in portfolio management:

Understanding the complementary characteristics of PE and PC enables more nuanced portfolio optimisation:

- Private Equity serves as an alpha-seeking allocation with the potential to drive long-term wealth accumulation, particularly for investors with high return targets and a tolerance for illiquidity and volatility.
- Private Credit provides a ballast function, enhancing portfolio stability through predictable yield and lower volatility. Its utility becomes pronounced in low-rate or risk-off environments, where capital preservation and steady cash flow become paramount.

A blended allocation can deliver both growth and stability, provided allocations are calibrated in line with the investor's liquidity preferences, risk tolerance, and strategic time horizon.

Conclusion:

The strategic integration of PE and PC enables investors to construct more resilient, opportunity-rich portfolios. When used together, these asset classes complement each other. PE drives long-term capital growth through opportunistic, high-conviction investments, while PC anchors the portfolio with steady income and lower volatility.

This dual allocation is not plug-and-play. Success in private markets hinges on an active, research-intensive approach. One that combines rigorous due diligence with a forward-looking perspective on market dynamics, liquidity needs, and investor-specific objectives.

Glacier Research would like to thank Alexander and Karl Engelhard for contributing to this week's *Funds on Friday.*

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