Top 10 with…

Joe Azelby
on private markets

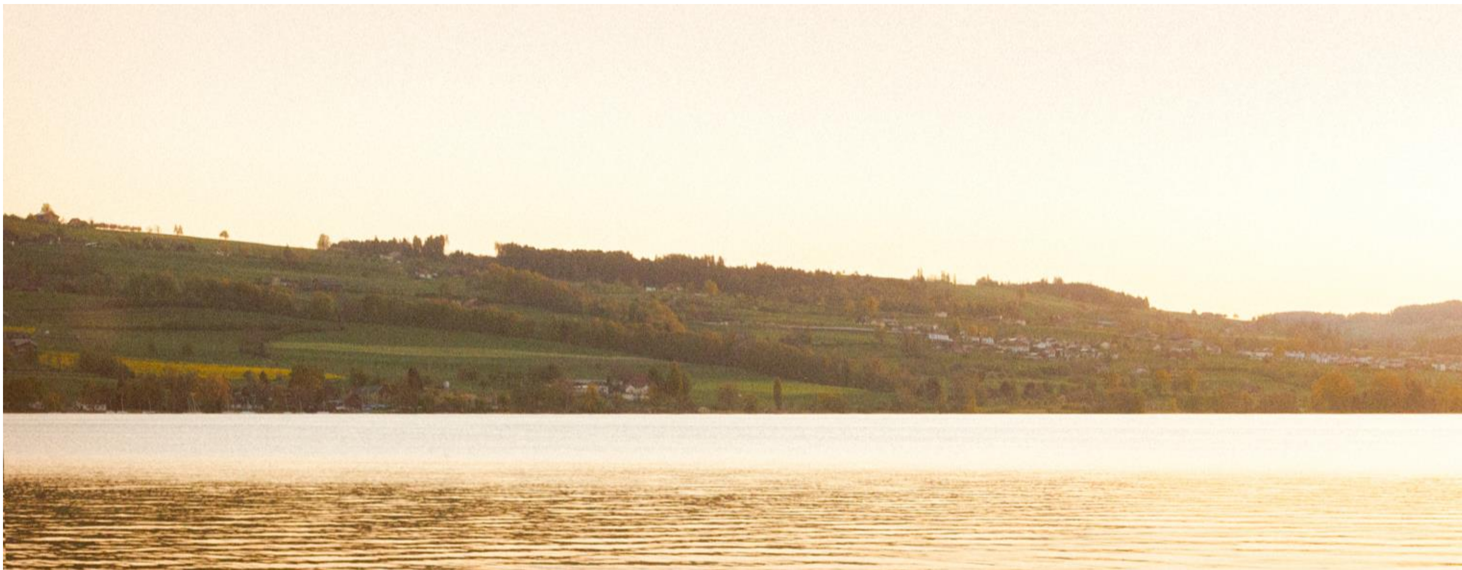
UBS

Content

To start off….

What are private markets investments?

These are non-listed investments into privately owned companies or assets that are not traded on a public exchange or stock market. Public markets feature mainstream investments such as bonds, shares, exchange traded funds etc, while private markets feature more alternative assets such as real estate, infrastructure, private equity, food & agriculture and private credit.



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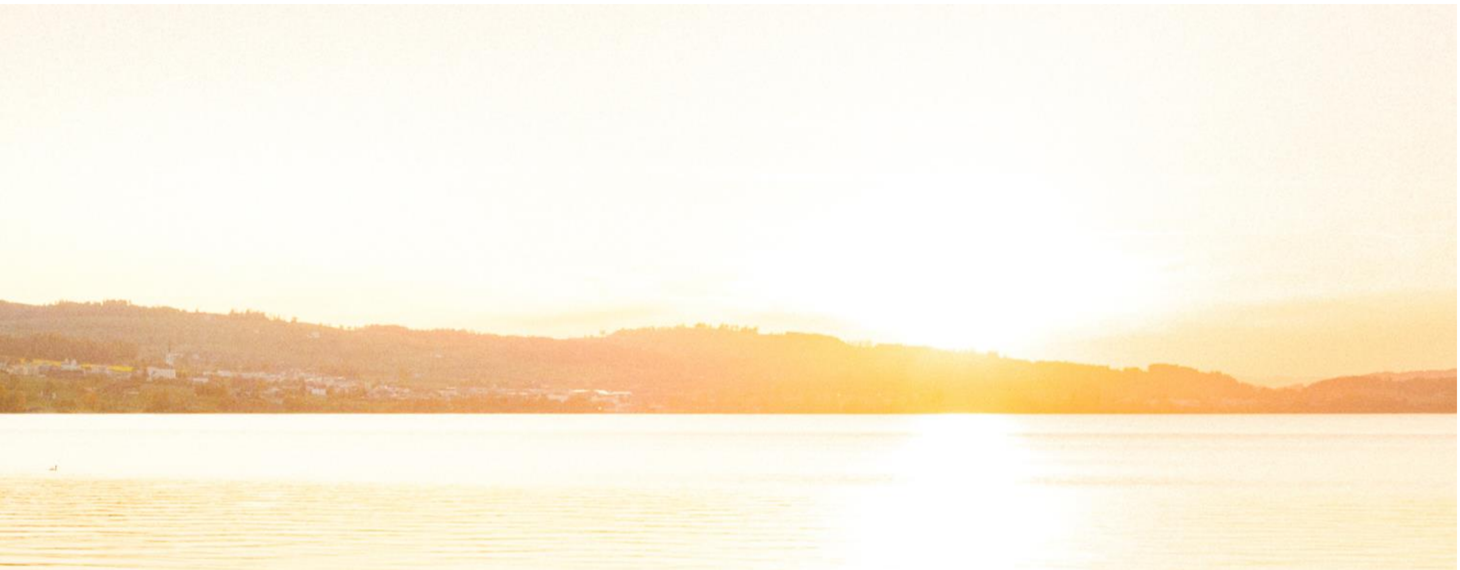

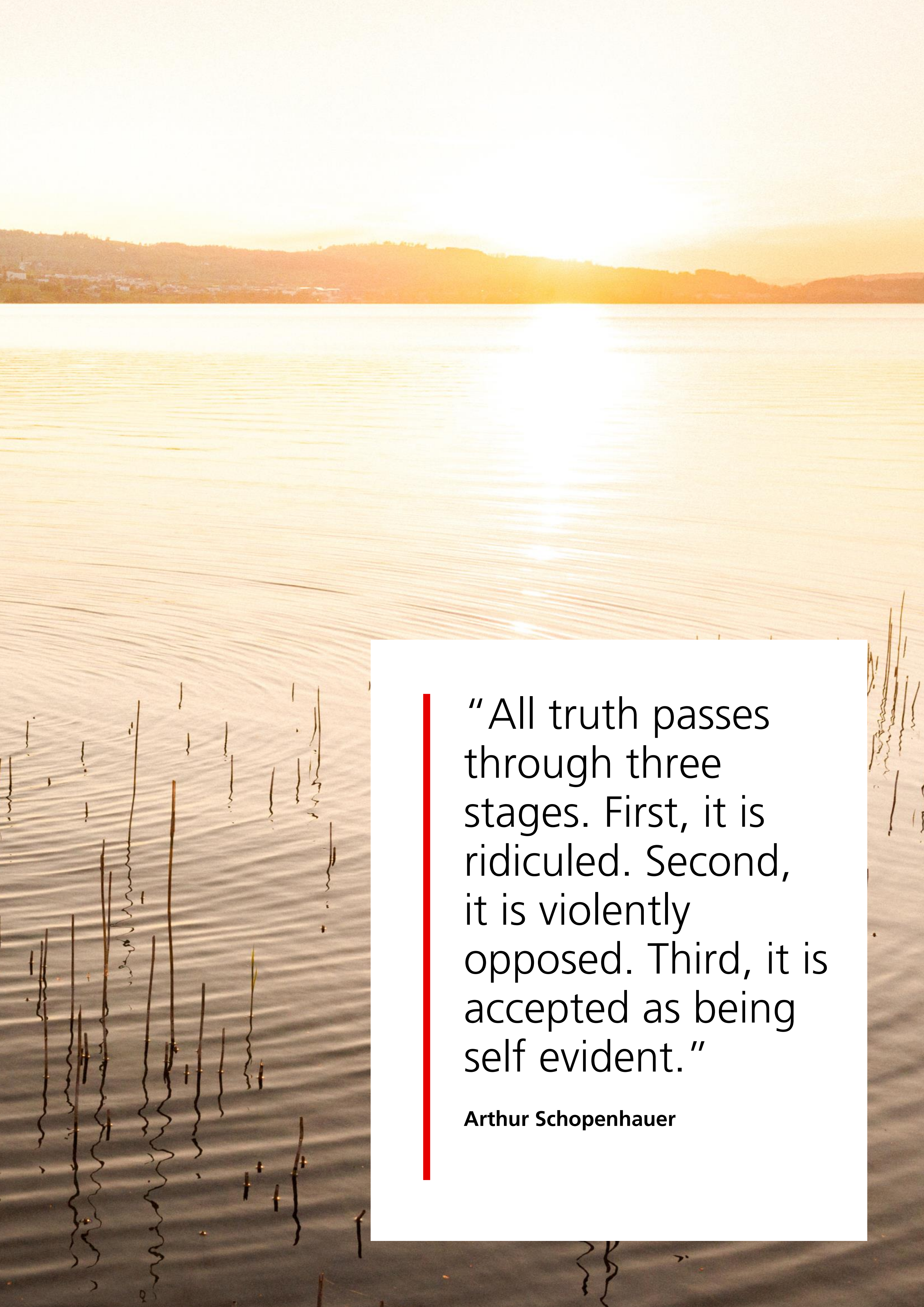

> “All truth passes through three stages. First, it is ridiculed. Second, it is violently opposed. Third, it is accepted as being self evident.”
>
> **Arthur Schopenhauer**

From niche to norm – private markets spur innovation

Innovations in the private markets space and growing niche sectors are taking this space by storm, addressing many of today's topical issues such as renewable energy, food security, transportation and healthcare.

Joe Azelby, Head of Real Estate & Private Markets within UBS Asset Management takes us through the current climate and the challenges and opportunities for investors in the private markets space.

Joe Azelby
Head of Real Estate
& Private Markets

1

Where are the opportunities for private markets investors?

In short, everywhere. Private markets investments are re-pricing downward to reflect higher interest rates, volatile stock markets and a mini but concerning banking crisis. Transaction volumes have dropped across private markets and liquidity comes at a high cost. And for investors focused on both sustainability and financial returns, private markets investments can offer an opportunity to deploy capital toward incremental, measurable impact that goes beyond what is generally achievable in public markets. The trick is identifying strong growth sectors and when to enter these new markets as an investor.

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From a thematic perspective, life sciences is seeing strong growth given the huge supply and demand imbalance in the sector. That growth has been driven by a number of factors, but one of them has been a significant increase in venture capital (VC), which has been deployed into university spin-out companies to help accelerate their growth and discovery of new treatments.

This originally started in the US. But we've seen it in more recent years in the UK, particularly in the markets around London, Oxford and Cambridge, which form the Golden Triangle. And we're also seeing the same sort of positive dynamics start to develop across a number of European markets.

Second, the private sector has been a key catalyst to supporting food security. The VC community also invests in food technology, such as agriculture technology, drones and robotics on farms, or water technology. Infrastructure capital, however, is really the most important capital source here. Growth equity and VC are investing in very innovative ideas.

However, infrastructure capital is what brings size and scope, has long-term impact and brings down costs. Long term, it is this type of infrastructure capital – not growth equity – that will bring down the cost of food in scale. Food investing only works when there is an endgame that supports scale and lower costs.

Third, the past year was marked by several major events that will influence the energy and renewables industry in 2023 and beyond. The most crucial one was obviously Russia's invasion of Ukraine, which led to elevated commodity prices around the world and has accelerated the rest of the world's drive to diversify its energy sources. Strategies are also embracing newer technologies, such as energy storage, eco-transport, green building technology, renewable natural gas (RNG / biomethane), hydrogen, etc., as there is increased conviction that these investments will further de-risk and become more mainstream in the long term, especially with the policy tailwinds.

For many investors, what they keep versus what they earn is more important. And so we're seeing the added value that a strong tax strategy can harness across the private markets space and can bring to an investment portfolio in terms of legal structure, asset selection, management decisions, and fund terms. Such strategies can also be strongly aligned with sustainability initiatives due to their long horizon and tax incentive synergies.

Finally, we are witnessing a democratization in private markets, with the investor base broadening in this area. This is opening up new doors to all types of investors who are looking for alternative sources of return.

2

Why is private markets investing particularly so attractive now?

It has always been attractive and remains so today. Diversification, lower volatility and market inefficiency all contribute to a portfolio's risk / return equation in a favorable way. In the current environment, investors continue to face the urgent challenge of how to best allocate portfolios to generate appreciation potential and income, while mitigating against volatility and wider challenges such as climate change. Institutional investors have held private market allocations for years and that is growing. But investing in private markets can be attractive for non-institutional investors too. They are drawn to the higher return attributes, lower correlation with public equity markets and inflation protection.

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At the same time, private markets can provide access to markets and strategies which span the investment universe, which would have been otherwise inaccessible. Private markets can provide an ability to trade liquidity to achieve higher returns for comparable levels of risk. They can also give investors more control over assets, as well as benefiting from skill premiums and illiquidity premiums.

Sustainability is not a new theme, but is increasingly prevalent in our world. The private markets space as mentioned before can provide a great access point to sustainable investments via innovative opportunities in high growth sectors. For many investors it has become front and center on their agendas and a growing part of the overall picture. There are some challenges in this space though.

The sustainability landscape is a complex and fast-evolving field largely as a result of increasing regulation around the world (e.g. SFDR in Europe, MAS ERM in Singapore, upcoming SDR in the UK), increasing scrutiny and expectation of transparency of sustainability by stakeholders and a lack of standardization in sustainability reporting and scoring (especially true in private markets).

These are some of the key challenges in the industry today that we are all contending with. Our approach to overcoming these challenges is to increase diversity and scale of our activities. Our global business includes real estate, food & agriculture, infrastructure, private equity, and private credit investments, plus evolving sectors such as renewable energy, life sciences, food security etc – each a distinct sub-asset class with a unique set of sustainability priorities, challenges, targets and initiatives (in terms of cost, resources, etc).

Thus, the material sustainability topics and challenges facing different areas of our private markets business varies significantly (eg the challenges surrounding real estate will vary from private equity). Therefore, each area requires a tailored approach to sustainability.

Buyers and sellers of private market assets are looking to the public market downward repricing of cash flows and risk to reflect what has changed in the bond and listed equity market.

3

How is the current macroeconomic environment impacting the private markets space?

2022 was undoubtedly a challenging year for private markets. Spreads between risk-free rates have narrowed or even reversed, leverage costs have soared and the economic outlook has weakened further. In this environment, it is crucial existing portfolios are positioned against some of the headwinds we know are coming.

A key theme which comes across in all the private markets sectors we cover, including real estate, infrastructure, food & agriculture, private equity and private credit, is that a business's or asset's capacity to pass on inflation to customers and tenants will be a determining factor for performance. We expect niche sectors such as life sciences, food security, renewable energy and sustainability focused infrastructure, to see the strongest structural drivers of demand – providing the crucial pricing power in setting rents and terms.

And with market uncertainty always comes opportunities for investors who are willing to make a call on pricing before stability returns. As some investors are under pressure to rebalance portfolios, there will be a short window where marketed investment stock exceeds buyer demand, creating an attractive entry point for long-term sector conviction calls at attractively repriced levels. Buyers and sellers of private market assets are looking to the public market downward repricing of cash flows and risk to reflect what has changed in the bond and listed equity market. And just as private markets adjust asset pricing downward, interest rates drop and the stock market goes up. Until a buyer and seller agree on a price for a particular asset, there is uncertainty over the valuation.

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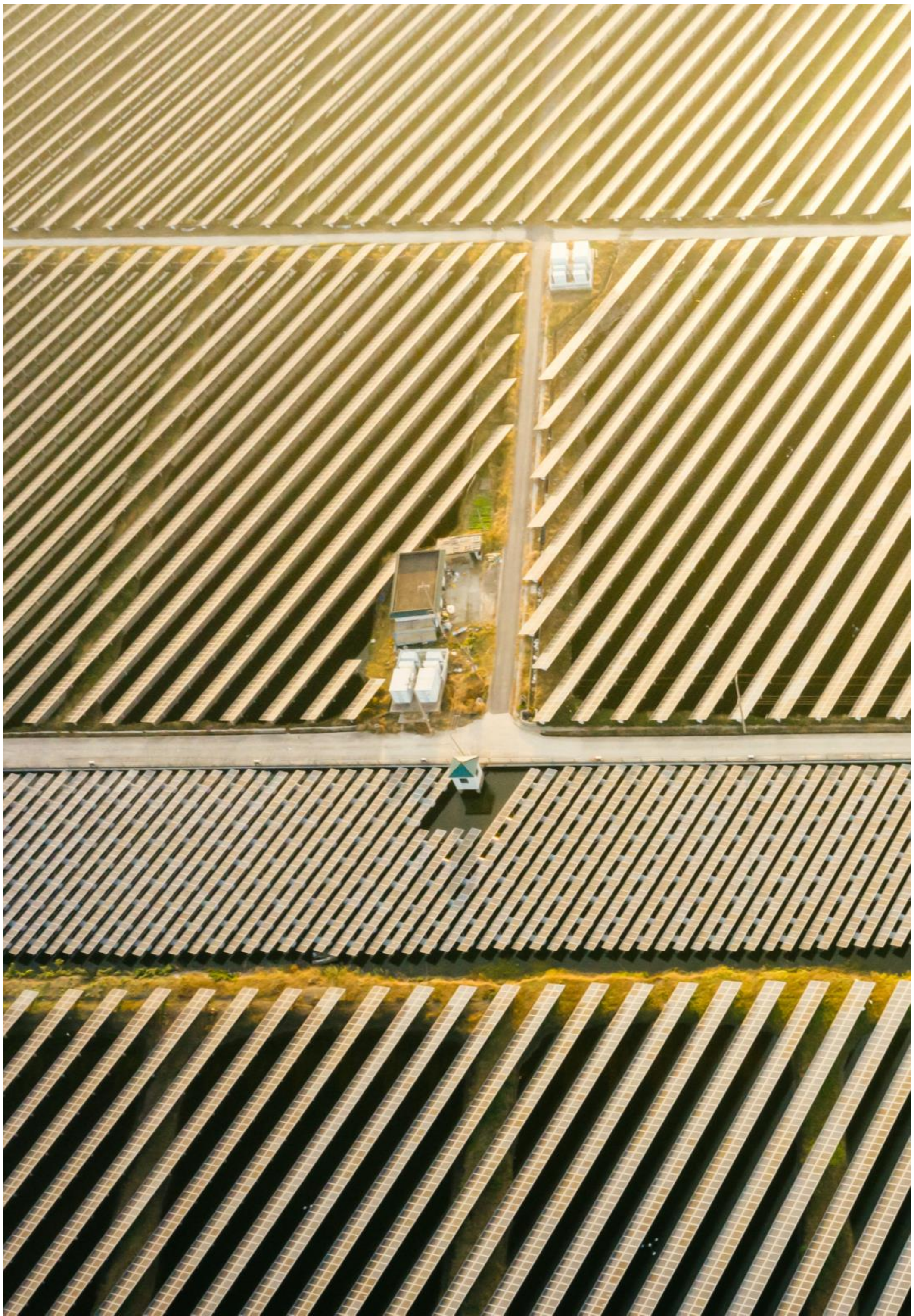
What are the current challenges?

The markets were relatively quiet in the first quarter of 2023… we are now seeing more activity and expect this to continue.



What has been going on in the public equity and debt markets has had an impact on the private markets. Stock market declines have caused portfolios to fall out of balance. Generally speaking though, there is less capital in the market than there was a year ago and investors are in some cases seeking redemptions from open-end commingled funds.

The markets were relatively quiet in the first quarter of 2023. However, we are now seeing more activity and expect this to continue. I suspect we will see normalcy over the course of the year, whatever that means in this cycle.

Looking back though, global private markets fundraising declined in 2022 overall when compared to 2021's record highs. The macroeconomic headwinds such as the rise in inflation and interest rates, and sharply negative public market performance triggered a denominator effect. LPs also scaled down new commitments.

However, after all data has been recorded, research estimates show that 2023 is going to be a strong fundraising year[1]. This ties into the now longer term thinking by LPs.

5

How can investors gain exposure to private markets?

We think it has become increasingly important for investors to consider exposure to private markets. In our view, private markets offer a combination of strong potential returns[1,2], a long-term focus, and access to innovative and fast-growing businesses.

Private markets investing can provide more differentiated return drivers than listed investments if managers are able to add value through active ownership and operational value creation. For investors able to commit capital for longer – and with a plan for managing risks arising from lower liquidity – we think these advantages can make private market investments a crucial part of most portfolios. As an example of our business's long-standing experience in private markets, UBS «Sima» stands as Switzerland's largest listed real estate fund.

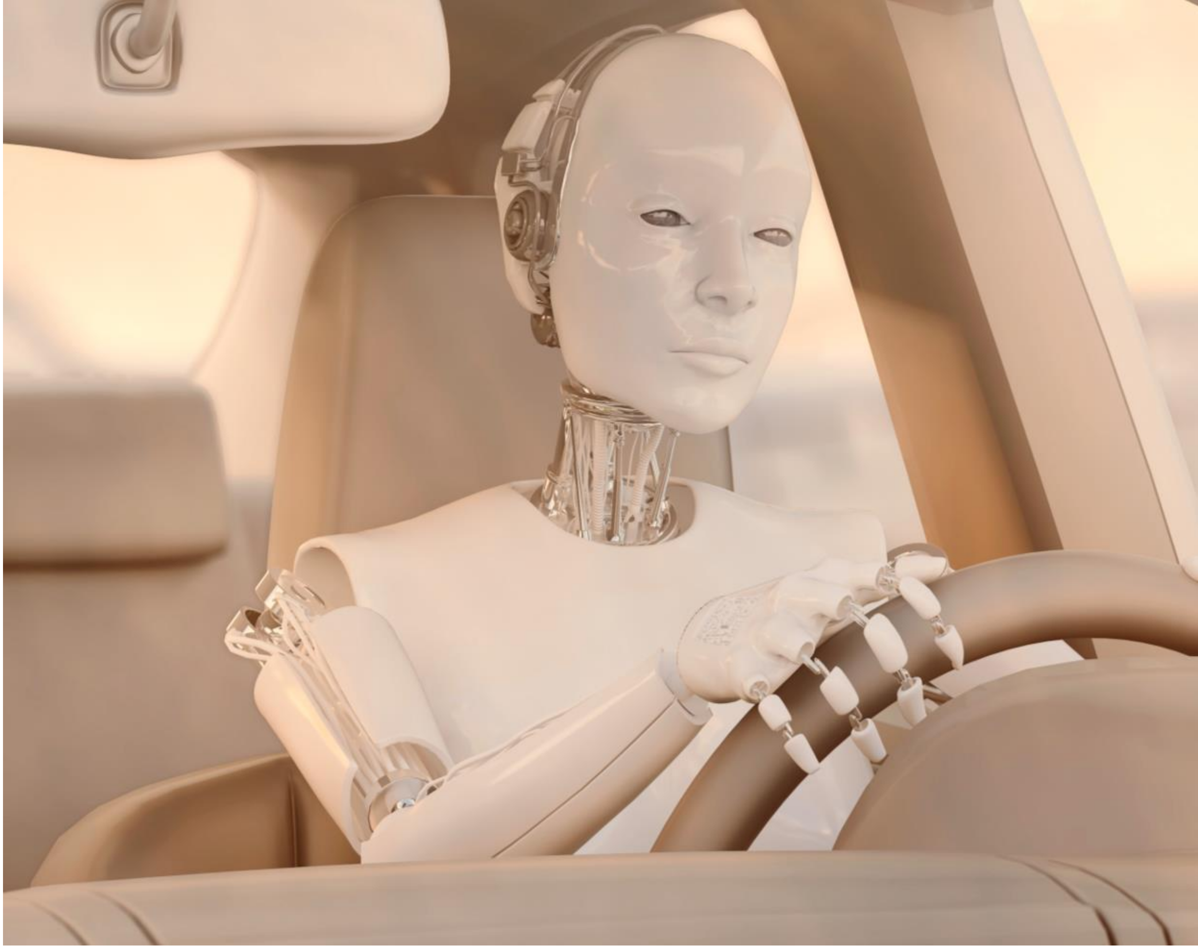
We also find niche, under-the-radar strategies with the potential to generate strong returns and/or capital gains particularly interesting. For example, through our business's broad sector expertise and integrated research capability, you can gain access to opportunities that are not publicly available. Our strong network also enables us to offer investors access to specialized fund managers and private market investments in the areas of real estate, infrastructure, private equity, food and agriculture and private credit.

While private markets face some of the same current headwinds as public markets, including elevated inflation and rising interest rates and heightened geopolitical risks, we don't see this as a reason for delaying investment. Skilled managers are well-placed to adapt to these challenges. In addition, we don't favor efforts to time private market investment given the long lead times for deploying capital and longer holding periods.

It is tempting for many investors to try to ramp up private markets exposure quickly by making large initial commitments, then filling in with smaller commitments as the initial investments begin to distribute. However, this approach can lead to a continual game of catch-up since new commitments take time to draw down and may not keep pace with distribution activity, as well as reducing flexibility in managing a program should the environment turn out to be much different than was initially expected.

A program of making relatively similarly-sized commitments to private markets on an annual basis may take longer to achieve the targeted asset allocation, but can also help ensure that the portfolio maintains a reasonable level of diversification and preserves the flexibility to reduce commitments and mitigate the denominator effect, and/or lean into areas of particular tactical interest should markets weaken. Moderately larger initial commitments, or allocations to strategies offering a higher velocity of capital, can help build allocations more quickly, but significant over-commitments can reduce flexibility and optionality exactly when it would be most valued.

Private markets are democratizing as non-institutional investors gain broader access to private markets opportunities and the ability to diversify their portfolios. In terms of regulation, the overhaul of the European Long-Term Investment Fund (ELTIF) regime represents a really interesting development; it enables new managers who have not previously been able to offer access to private wealth customers to join the game, while also increasing optionality for those players already serving private wealth clients. We expect the new ELTIF regime to be friendly to both investment managers and clients. It is something we see as highly beneficial.



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For which type of investors are private markets suitable?

Private markets are suitable for a wide range of investors, including high net worth individuals, institutional investors such as pension funds, family offices, insurance companies, sovereigns and private equity firms. These companies are frequently hubs for cutting-edge technology and innovation, and usually prefer to stay private to incur less restrictions than public ones. In addition, as they are not publicly traded, they tend to generate higher returns[1,2].

There are several dimensions to consider when venturing into private markets, and one of these is certainly diversification. This is particularly true for private equity, where investors usually have plenty of choice in terms of strategies and investment styles to consider: small to medium-buyout, large buyout, mega buyout, seed stage, early stage and late-stage venture capital along with different growth strategies.

…the best time to increase rather than reduce exposure is during times of distress…

Second, is the liquidity preference of an investor. It is crucial that clients understand and tolerate illiquidity. Even semi-liquid private markets investments can provide only idiosyncratic liquidity and won't be able to meet redemption requests in times of distressed markets, as evidenced by recent developments. On the plus side, this will prevent panic selling. Often, the best time to increase rather than reduce exposure is during times of distress, and post-crises vintage years have often proven to be the strongest in terms of performance.

Therefore, the new semi-liquid structures that allow subscriptions on a monthly or quarterly basis allow clients to continuously add to their alternatives exposure over time and therefore achieve a nice cost-averaging effect. The third dimension setting apart private markets investments is the degree of control over the underlying assets. For investors who care about sustainable investing, private market investments are a good way to have impact.

Another point worth mentioning is the strong fundraising environment seen in 2022 (especially for infrastructure, which saw a record year) has slowed down in 2023 due to the denominator effect – some investors are reaching their private market allocation targets due to lagging public market performance. However, weaker fundraising could actually create a more balanced investing environment as there is less dry powder chasing the same deals. This is an opportunity for investors to gain exposure to high quality assets at more reasonable valuations as there is less competition.

All investors should participate in private markets provided the industry can deliver suitable vehicles for those investors and properly explain what they own and how it is different from stocks and bonds. The big issue is liquidity. There are times where more investors want out of a private fund or asset class than want to come in. Real estate is going through that at the moment and liquidity is scarce for those looking for it.

7

What is the right weight of private markets in a portfolio?

In today's inflationary environment, private markets investments have become increasingly important. In the past, a diversified portfolio would offer enhanced protection for investors' purchasing power – especially when compared to more traditional equity / bond portfolios.

However, the market volatility is causing investors in the public markets to look for a hedge (i.e. protection). Even the traditional 60 / 40 portfolio is not satisfying investors. Although there has been more monetary tightening by central banks to control inflation, investors remain cautious.

This is opening more opportunities and appetite for private markets. Investment into private markets depends on each investor's preferences and circumstances, so there is no right allocation per se, but, investors should seek out an experienced manager to identify quality investment opportunities across the spectrum of private markets.

The general trend in the industry would indicate that an allocation of around 10% for more conservative investors and up to 20% for more aggressive investors would makes sense. Similarly, it's generally appreciated to maintain part of wealth in liquid investments despite potentially lower returns.

Private markets allocations can be tilted to more yield-oriented or more capital appreciation-focused investments, but this depends on the objectives of the investor. For example, this could be around 20% or more if you don't need liquidity or around 10% or less if you do.

In our view, selection and diversification will play an even more significant role in investors' portfolio construction processes as a means of increased downside protection going forward. Today's crowded market means that fund managers have to think more carefully about how they deploy capital. Achieving appropriate sector diversification in order to avoid region specific concentration and return dependence will likely be a key driver of growth in private markets.

In general, we take a top-down approach regarding the regional allocation of the underlying assets. This general strategic allocation is overlaid with tactical considerations influenced by the individual investment opportunities available.

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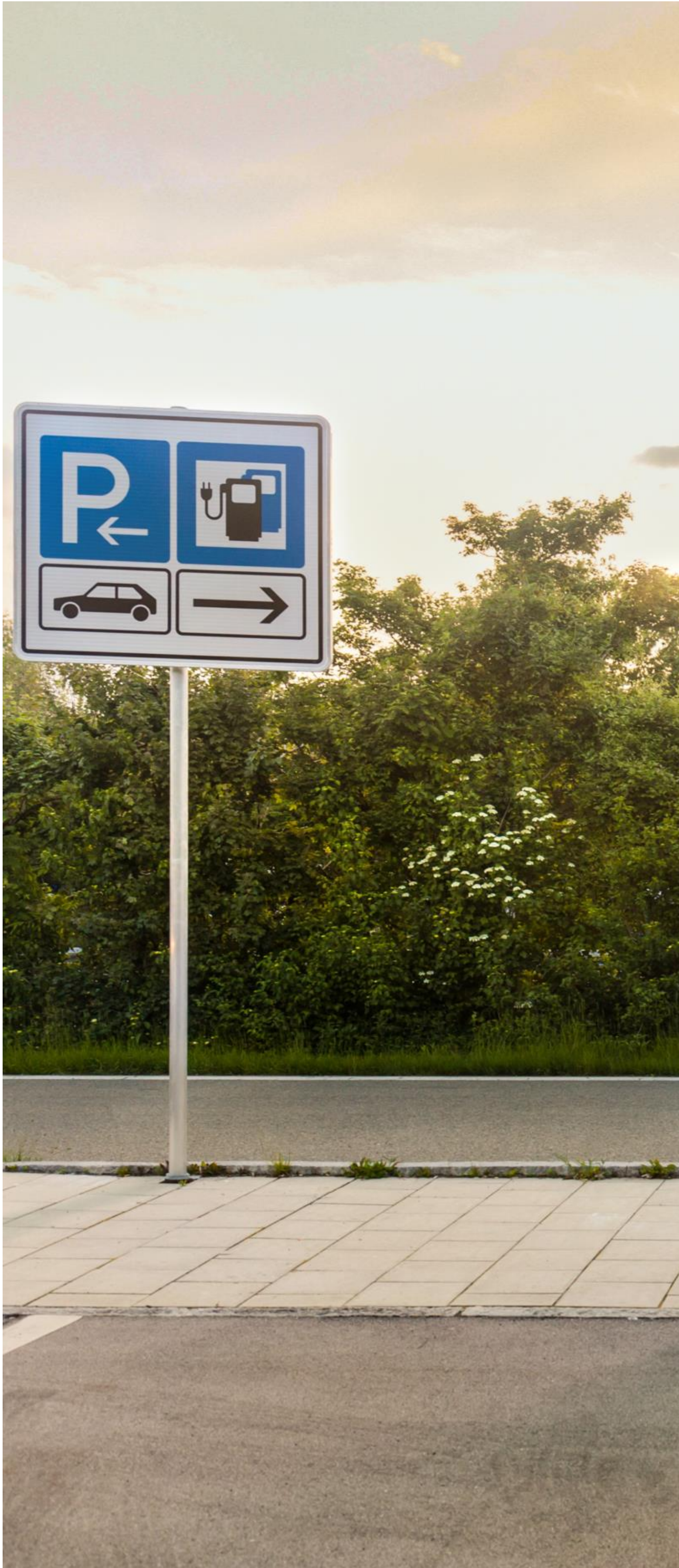
8

What's your view on integrating sustainability factors into private market solutions?

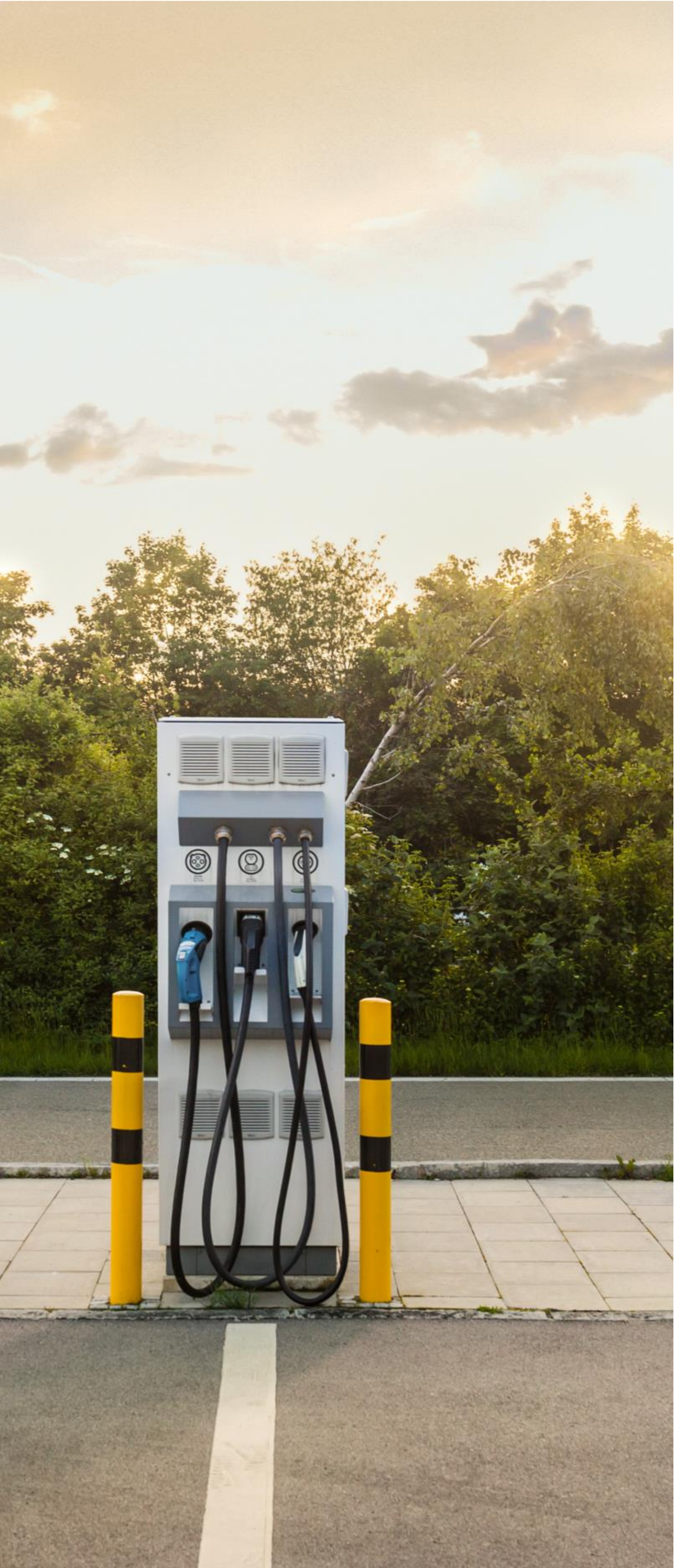


In many ways, private markets is an ideal fit for a sustainability or impact-focused investor. It has become a market requirement. And if you don't meet that requirement you run the risk that your asset will not be leased and employed in what it was built to do. There will be many stranded assets in the years ahead as requirements for sustainability rise.

Private market investments offer clients control over the end asset, enabling capital to directly influence how an asset is managed and the sustainability or impact approach being pursued on the ground. Private market solutions offer clients the ability to create tailor-made, hands on investments with whatever sustainability tilt or impact approach is desired.

In the existing REPM platform, we firmly believe that sustainability is part of our investment management responsibility and linked with long-term financial returns and risk profiles of our assets and funds. Integrating sustainability factors into our processes and products therefore is truly necessary as we strive to deliver investment options and service to our clients.

We recognize that real assets, such as properties and infrastructure, contribute significantly to CO_2 emissions and the consumption of natural resources, real estate accounting for ca. 40%[3] of global emissions, food and forestry account for ~ 24%[3], while transportation is another 14%[4].



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REPM encompasses all these industries (and more), and one of our primary challenges lies in this diversity of our business, while maintaining consistency of sustainability approaches and standards. It is our duty to hold ourselves accountable in protecting our clients' assets in this changing climate as well as mitigating adverse impacts on the environments in which we operate.

One example of a sustainability factor is physical risk; as our climate changes so too is our weather and consequently the physical risk faced by our buildings. Weather-related damage costs are rising; in 2021 natural disasters caused losses of around USD 280 billion while less than half of those losses were insured, meaning that approximately USD 160 billion of weather-related damage costs were incurred by the owners of those damaged assets[4].

Not to mention that as the frequency and severity of these events increases, the buildings that are insured will see growing premiums to reflect the growing risks. The integration of physical risk analysis, both on new acquisitions and existing portfolios, is therefore a critical component to assess the future financial risk in our assets and therefore is firmly embedded into our transaction and monitoring processes across all our private market offerings.

9

How do you ensure alignment of interest across investors?

Private markets investments have grown to be an integral part of investors' portfolios who are drawn to the potential return enhancement, inflation protection and diversification attributes. But ultimately, investors' priorities determine which private market assets to choose. The last decade has also seen considerable growth in this space.

We've seen that different types of investors have differing risk tolerances, for instance, and need to consider which assets across the private markets spectrum align with their investment horizons and return objectives. For example, a more risk-tolerant investor seeking to maximize long-term capital may prefer to allocate to higher-returning but higher-risk and less-liquid private market assets.

We also ensure that our clients appreciate the broader market, especially the risks...

Allocation to private equity or infrastructure, for example, can provide exposure that can improve diversification given the low correlation to stock markets. Some investors prefer a more balanced investment approach to gain access to upside strategies with some downside protection. We've also seen that a broader suite of assets can also boost diversification.

For us at REPM, we educate ourselves about trends and current market opportunities. We also ensure that our clients appreciate the broader market, especially the risks and considerations that may not be visible. Our specialists understand the differences between strategies, and have broad client exposure across sectors, which allows them to have additional insights about trends, opportunities, and other issues. We also apply the same long-term mindset and collective decision making when it comes to managing ideas as a company.

In terms of supply, firms like UBS are creating dedicated units to look after distributors who serve private wealth clients, which means our understanding of what they actually need in order to invest in private markets is increasing significantly. It isn't a question of simply opening up existing solutions, which were built for institutional investors, to the private wealth market.

Finally, you want the financial incentives of your investments team to be directly tied to the clients' investment outcomes. Clients are ready and willing to pay for strong performance and we as an industry have compensation structures that reflect that.

10

What is your experience and track record in private markets investing and how do you differentiative from your competitors?

We've a history of more than 80 years in private markets investing, having launched our first real estate fund back in 1943. REPM offers integrated solutions to optimize the diversification of client portfolios, whether that be in targeting access-restricted private equity strategies or niche real estate strategies. Our capabilities are broad, focusing on the risk / return spectrum, ranging from core to value-add and opportunistic strategies.

We believe that private markets should be a long-term structural component of asset allocation for all types of investors. We aim to continue building our private markets platform, focusing on specialized and innovative approaches covering the full spectrum of private markets.

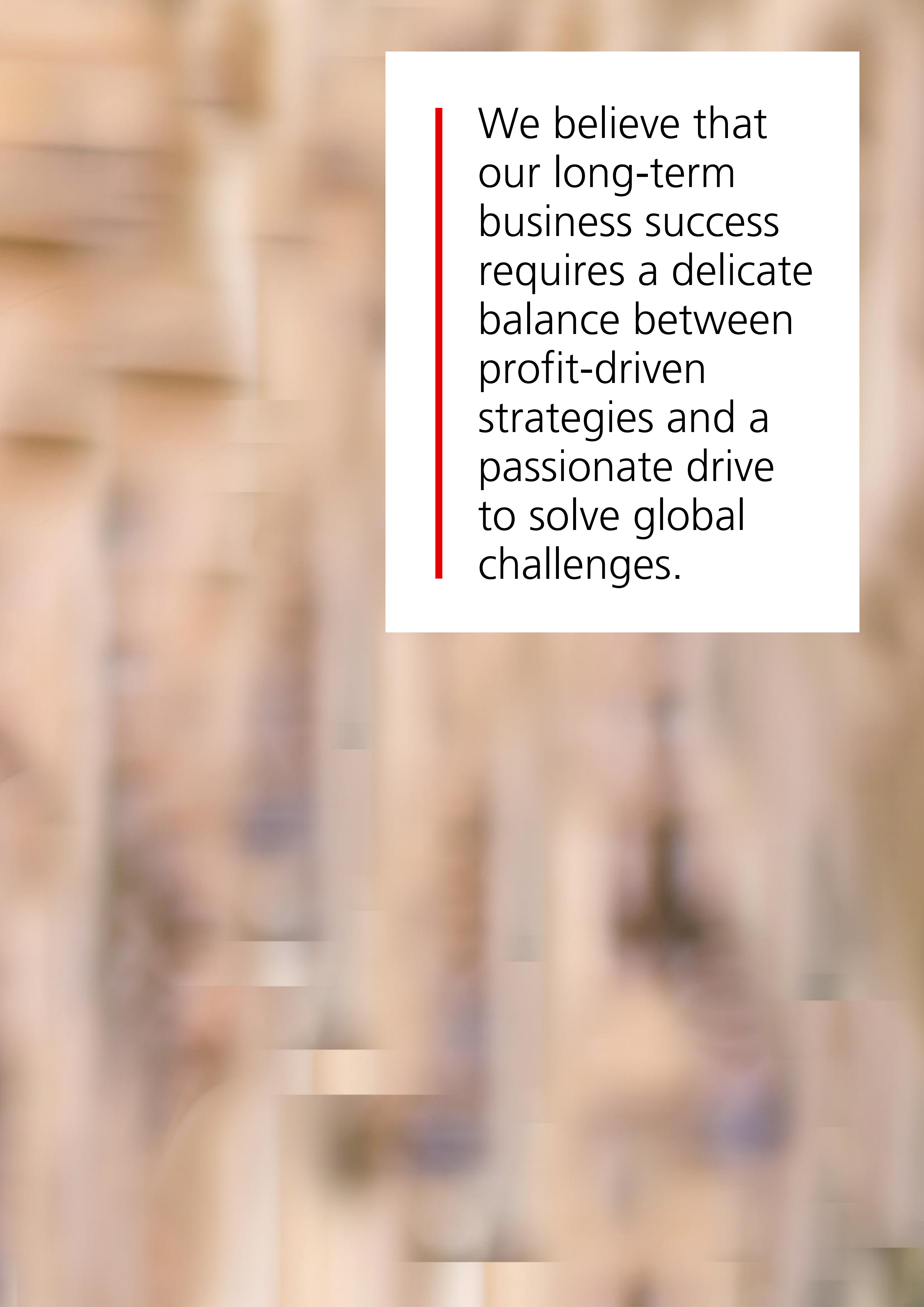
This includes our commitment to investing, managing and building sustainable and tangible operating assets, be it green buildings, renewable assets or working with partners to develop life sciences facilities. Our advantage is having real estate, infrastructure, food & agriculture, private equity and private credit capabilities all under one roof. The energy transition and decarbonization will force the convergence of these capabilities.

Almost every physical asset that needs to be created or recreated will touch these areas and needs the collective knowledge, insights and execution capabilities across them to meet the biggest challenge of our time.

REPM is venturing into new areas of investment and exploring new ground. For us, these types of investment have moved from niche to norm, with the aim of having influence and tremendous impact. This ties into the notion of the democratization of private markets and is testament to our efforts to widen shareholdership of investments through new avenues and structures.

We believe that our long-term business success requires a delicate balance between profit-driven strategies and a passionate drive to solve global challenges. And so we aim provide investors with the opportunity to be part of a movement that seeks to make a positive impact without sacrificing financial growth.

Source: **1** McKinsey Global Private Markets Review 2023, Private markets turn down the volume, March 2023; **2** McKinsey; Bloomberg; Burgis, Performance by asset class (1-year pooled IRR for 2000-19 vintage funds); IRR for 2022 is YTD as of 30 September 2022; **3** World Green Building Council (WorldGBC) and the UN Environment Programme; **4** US Environmental Protection Agency: Global Emissions by Economic Sector, based on global emissions from 2010; **5** Swiss Re, Natural catastrophes in 2021: the floodgates are open, March 2022.



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For more information, please contact:

UBS Asset Management
Real Estate & Private Markets (REPM)

sh-am-private-markets-research@ubs.com

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