The role of private markets in a portfolio context

Investment strategy insights

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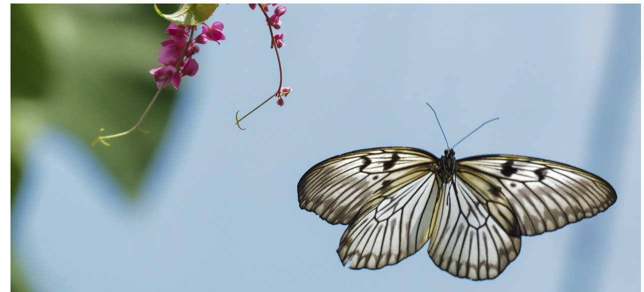
- CIO believes that private markets can diversify and potentially smooth portfolio returns, with private equity and private debt expected to yield around 11% and 9% per year, respectively, over a full business cycle.
- The shift away from public listing suggests private market investing may grow in importance as a means to invest in certain fast-growing companies and sectors not available through listed stock markets.
- The following paper aims to explore how building a private market allocation involves careful planning based on individual financial circumstances and objectives, mindful of liquidity needs and the unique risks of this long-term asset class.



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CIO believes that alternative investments should be a key component of long-term portfolios for those investors that are willing and able to bear their unique risks.

They have the potential to help diversify return sources and smooth portfolio returns, as part of a well-diversified and multi-asset investment strategy. Investing in private markets —those not listed on a public exchange—may provide access to fast-growing companies that would otherwise be out of reach, align with powerful long-term trends like digitalization and decarbonization, and allow investors with long-term spending goals for beyond their lifetime to match their liabilities with assets that have comparably long investment horizons.

In this paper we briefly explore reasons why private assets may have a role to play in portfolios today. We describe general approaches to build a private markets allocation, subject to an investor's particular risk appetite and individual financial circumstances. And we conclude by exploring some of the unique risks that investors in private markets need to understand and manage.

Three reasons to consider private markets

First, we expect private equity and private debt to return around 11% and 9% per year respectively over a full business cycle. Based on CIO analysis, a balanced investor that replaced up to 10% of their global public equity exposure with private equity exposure could see around 20–30 basis points of additional expected returns each year over the long term. We think the long-term case for private equity in a well-diversified portfolio remains strong, as we expect a continuation of its outperformance since 1993 (based on vintage year internal rates of return comparison for global private equity and global public equity equivalent using Cambridge Associates and MSCI AC World data, respectively).

Second, adding private market exposure today can provide access to some of the world's most exciting companies.

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More firms are choosing to stay private, delay listings, or avoid them altogether. Between 2000 and 2023, the number of private-equity-backed companies has risen sixfold to nearly 11,000. This is a trend that we think is unlikely to reverse. Investors who overlook these opportunities risk having long-term underexposure to those fast-growing sectors of the economy whose companies choose not to list.

Third, adding private market exposure may help investors steady their portfolio returns. Locking up capital for longer also has its advantages, giving fund managers more scope to take advantage of market dislocations, and protecting investors from behavioral biases like panic selling. A CIO analysis shows that adding private equity could help reduce the expected swings in an investor's portfolio—i.e., the reported volatility—by about 30 basis points per annum over a longer time horizon.

What additional factors do investors need to consider when looking at private markets?

Investing in private markets requires investors to bear different types of risks—and adopt a more strategic view—than those of public markets.

Investors in public markets can invest at any time, making it easier to achieve fully invested portfolios that match their long-term asset class targets almost immediately. For private markets, having a fully invested portfolio typically takes a few years to build and to maintain. For example, many private market managers only gradually deploy capital over a 4–5-year investment period. And as private market managers partly or fully exit investments and pay money or stock back to end investors—a process known as making distributions—the share of a total portfolio invested in private markets will decline. This underscores the need for end investors to continuously re-invest in private markets in order to maintain their private market weightings.

Three key steps to building an allocation to private markets

Investors considering putting money to work in private markets for the first time can consider the three following steps:

1. Construct an investment plan. The decisions around investing in private markets differ from investor to investor. An investor's overall plan should include their objectives, risk profile, individual preferences, time horizon, and liquidity constraints. This plan informs the types of private assets an investor can consider, as well as the share they hold in their portfolio.

As a general rule, holding up to 20% of a liquid portfolio in private assets should enable investors whose plans allow for illiquid private assets to avoid running short of cash, including in periods of market stress. This allocation may rise up to 40% if an investor has modest cash flow needs of their portfolio and/or can draw on liquidity from another source.

2. Consider how to adapt this investment plan for particular financial needs. Investors whose primary need is to raise income from their investments may want to consider portfolios that generate stable returns through steady operational or senior secured income. In the event that such an investor begins with a public-market-dominated portfolio chiefly invested in fixed income, an allocation of 20% to private markets would likely be tilted toward income-bearing assets that do not add excessive volatility to portfolios. These can include private debt, private real estate, and private infrastructure, with most likely only a modest allocation to private equity. The end portfolio would likely involve funding this private market allocation primarily from public fixed income.

On the other hand, investors whose main aim is to grow the value of their wealth through rising capital values could aim to generate higher returns from a long-term portfolio focused on private equity strategies. An all-public equity investor could fund their private equity allocation one-for-one from listed stocks.

3. Consider how consistency impacts overall private market portfolio allocations. The different mechanics between public and private markets mean investing in the latter may require a commitment to invest continuously and in a diversified manner in order to reach long-term allocations. Let's look at a brief example to understand why.

Imagine an investor decides to invest in just a single private market fund. In the beginning, the investor's committed money for deals, expenses, and fees—known as capital calls—leads to negative net cash flows and a rising net asset value of their position and exposure to the asset class. When underlying portfolio positions start to reach maturity and are exited/sold, capital is distributed back to investors. This continues until the net asset value reaches zero. With no reinvestment, the investor's share of their portfolio in private assets will fall to zero.

Compared to the first example, building a program with continuous commitments to multiple private markets funds likely prevents the allocation from falling to zero. Replacing maturing fund investments with new ones allows investors to reach a steady target allocation to private markets and maintain it. Once a private market program has reached a steady state, distributions alone can finance new capital calls and potentially even generate a "perpetual" stream of cash flows.

When it comes to the practicalities of building private market exposure, an investor's choice of tools to build positions depends on their circumstances, like their depth of knowledge and their total pot of wealth. But generally, building and—more importantly—maintaining a private market portfolio can be divided into three different phases known as ramp up (year 1 and 2), build out (year 3 and 4), and maintenance (after year 5).

Initial investments may focus on private market approaches that allocate money to multiple managers for diversification purposes. Investors may also consider so-called evergreen or perpetual capital approaches that are fully funded from day one and invest in existing assets, as opposed to traditional capital call approaches where money is called from investors but not invested until sometime after.

What are some of the risks of investing in private markets?

Investing in private markets comes with a number of additional risks to public market investing. For example:

- It might not be possible to sell an investment easily or quickly (illiquidity)
- Fees on private market investments may be higher than in public markets
- The cash flows generated from these investments can be unpredictable
- Investors give up some control over their investment in exchange for potentially higher returns
- There may be limited information on performance compared to listed investments
- Investors may commit money without knowing exactly what they're investing in (blind pool risk)
- Some private market strategies may use borrowed money (leverage), which can increase risk.

Appendix

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