Benefits and Pensions MONITOR Meetings & Events WEBINAR

Invesco

Four Key Considerations for Private Markets Investing

The growth of private markets has really just been nothing short of phenomenal over at least the last decade, says Danielle Singer (CFA), Head of North America Client Solutions for Invesco. And investors are not sitting on the sidelines, they are looking for additional diversified sources of growth in income that may otherwise not be found in public markets.

She told the *Benefits and Pensions Monitor* Meeting & Events 'Key Considerations for Private Markets Investing' session, with Neil Blundell, Invesco's Head of Global Client Solutions and Alternative Solutions, and Jeff Bennett (CFA), its Senior Portfolio Manager, Head of Manager Selection, that industry research polls and surveys point to continued strong increase in allocation to alternative investments by institutional investors over the next three years and beyond.

At least 51 per cent of the plans it surveyed are managing some of their allocations in-house and want to increase that with the number one reason being to have a clear alignment of strategies to longer term objectives.

Singer: *What are some of the opportunities and challenges of investing in these markets?*

Blundell: Growth has been tremendous in the alternatives space; fundraising activity has been increasing over the past year and we've been seeing tremendous activity this year as well. There's been 5x growth over the last 15 years within private assets vs. public markets, which is roughly half of that. The breadth of investment opportunity has also grown where we had a few asset classes in the 1980s to start with; the opportunity set has really expanded since then into many sub-asset classes with unique characteristics. We've also seen average allocations for institutions increase across DB pensions, insurance, and E&F market segments. However, there are added challenges when investing in private markets that often prohibit investors from achieving target exposures. In achieving those targets, investors need increased staff, technology and infrastructure. Typically, asset allocation is often the starting point in terms of what are sub-asset classes to include and that's a unique problem for investors. Factors such as the risk and return characteristics, specific liabilities or capital charges, as well as modeling which can be complicated to meaningfully formulate a strategic asset allocation. Once you do that, you have to go out and source those investments. How do you do that given the wide dispersion in terms of the range of outcomes even within asset classes across private markets? – understanding those facets and doing the appropriate investment and operational due diligence to fully understand the quantitative and qualitative aspects of an opportunity is essential when investing in private markets. Other challenges such as implementation, deployment, the right level of diversification, fees, operations and reporting are also challenges that come into play when investing in private markets that often lead to under-deployment in this space.

Singer: *Given the breadth of these markets what is the optimal asset allocation to maximize outcomes?*

Blundell: If we dive down deeper into the sub-asset classes, we have private equity and large cap buyout, but then there's mid-market buyout. There's earlier stage, whether that's within venture with its early release days, impact investing, or expansion capital. So there's multiple sub-asset classes that you can potentially invest in, even within private equity.

The same thing is true for real estate and infrastructure. Whether it's core, core plus, value-add, opportunistic, greenfield, brownfield, or renewables, there's a number of different profiles within infrastructure with different links to GDP or contractual income, varying levels of capital appreciation versus income which creates a pretty diverse universe. Specific to private credit, people tend to be familiar with senior direct lending, 1st lien and 2nd lien corporates and that could go down to special situations and distressed within the corporate universe, but we've also seen expansion within the asset class. We've seen real estate debt, whether it's senior or mezz, infrastructure debt whether it's investment grade or high yield, as well as other classes such as asset-backed securities, venture lending, insurance-linked securities, etc.

> THERE'S LOTS OF VARIABILITY IN EACH OF THESE ASSET CLASSES. DIFFERENT APPROACHES OF LEVERAGE AND VARYING LEVELS OF ATTACHMENT POINTS IN TERMS OF THE SECURITIES THEMSELVES.
>
> – Neil Blundell

It goes back to my point. There's lots of variability in each of these asset classes. Different approaches of leverage and varying levels of attachment points in terms of the securities themselves. Each has its own unique characteristics and can be potentially utilized and combined to create various different outcomes whether it's growth you're seeking in your portfolio, inflation protection, or income. We've done a lot of work to evaluate these asset classes using our proprietary analytics engine, Invesco Vision, which allows us to easily construct private markets allocations and we've incorporated our return assumptions through our proprietary CMAs across public and private markets as well as risk forecasts through BarraOne. This allows us to answer how to allocate to a pure private markets portfolio, but also understand the outcomes when we blend in public markets. We de-smooth private markets data so they're referenceable in a portfolio construct vs. publics. We see a clear shift in the efficient frontier when we incorporate private markets and that has been appealing to a lot of investors. the tool also allows us to look at liability matching, factor exposures, as well as cross correlations between publics and privates. The tool also includes stress-testing capabilities to understand potential outcomes holistically. But it doesn't end there – diversification within private markets is a multi-dimensional process and we seek to target diversification across sub-strategies, managers, vintages, investment types (primaries, secondaries, and co-investments), and geographies. We really look to understand the opportunity set and sub-asset classes, the relative attractiveness of these sub-asset classes, and how to effectively source and deploy these assets with a full understanding of operational complexities to create a portfolio that meets unique objectives.

Singer: *What tools are metrics are available to investors to help navigate private markets?*

Bennett: We try to evaluate private markets in substantially the same way we deal with public markets. It starts with capital market assumption. Public capital market assumptions today are broadly lower than they've been historically. They're lower today as well for private markets, but still substantially higher than what's available for similar public market asset classes.

We try to evaluate each private market asset class on a couple of key dimensions.

First is valuations. Here, we're looking at valuations in that each asset class relative to their own history, but as well, and often, more importantly, relative to what's available in the public markets.

The second key metric we focus on is fundamentals – really trying to understand the supply demand dynamics in a space conducive to prospective returns and whether they're continuing to be attractive relative to history, and whether risk levels are in line with historical expectations for delivering not just a high total return, but a high risk adjusted return over time.

The third dimension we look at is the macro regime environment. Is it going to provide a head wind or a tailwind for the strategy?

So, to keep the pipeline clear, if we expect returns to be attractive going forward and the supply demand dynamics are still favourable, we'll see a robust opportunity.

Singer: *Any thoughts on private equity and infrastructure?*

Bennett: It makes a lot of sense that investors are interested in private equity. With the client evaluations in public equity markets, there's going to be an expectation that private transactions are attractive over the foreseeable future as public market companies offer more attractive valuations for private equity managers.

In addition, the volatility and the decline of the IPO markets may lead to a secondary opportunity for private equity to provide capital to late stage venture firms which would otherwise access the IPO market.

When we think about infrastructure, that also makes sense. We look at it relative to other inflation-linked sources like inflation protected securities where we see attractive valuations. Given what we've seen with regards to inflation, it makes a ton of sense to invest in that space. There's very few places in the world that offer an ability to access an attractive yield that's real and will grow with inflation. Real estate and infrastructure offer that.

> THERE'S VERY FEW PLACES IN THE WORLD THAT OFFER AN ABILITY TO ACCESS AN ATTRACTIVE YIELD THAT'S REAL AND WILL GROW WITH INFLATION. REAL ESTATE AND INFRASTRUCTURE OFFER THAT.
>
> – Jeff Bennett

Singer: *Is there a challenge in overcoming implementation complexities?*

Blundell: Ultimately, what we've done to help is take client portfolio and be a second pair of eyes [through our proprietary analytics engine, Invesco Vision]. Typically, it's a complimentary service where we can account for various scenarios to examine whether the client is achieving their expected objectives.

In some instances, if clients want to source certain types of assets, we can share our research and investment and operational due diligence through our advisory offering to help clients make more informed decisions, but we offer various access points and implementation routes.

We understand that many investors are at different points of the investment cycle and we're able to help from sourcing investments and providing advisory access all the way down to implementation. **BPM**

CLICK HERE TO VIEW THE FULL WEBINAR