PGIM

IAS PORTFOLIO INSIGHTS

HARNESSING THE POTENTIAL OF PRIVATE ASSETS


Junying Shen
junying.shen@pgim.com

Michelle Teng, PhD
michelle.teng@pgim.com

Private investments have gone mainstream in all types of institutional portfolios including corporate pension funds, sovereign wealth funds, endowments, foundations, *etc*. As interest rates fell and stayed low over the past decade, expected returns of traditional assets such as public fixed income became muted, while private markets gained traction due to easier financing, abundant leverage and access to skilled managers. Portfolio allocations to private assets (equity, debt and real estate) have increased markedly. In addition to assumed higher expected returns than public markets, CIOs seek various private assets for portfolio diversification benefits and long-term income streams as alternative solutions for asset-liability management. Nevertheless, under the backdrop of increasing institutional private asset allocations is CIOs' ever-rising need to understand how private assets interact with the rest of their portfolios and how to quantitatively evaluate asset allocation decisions with both public and private assets.

One concern with substantial allocations to private assets is the implication for portfolio liquidity. Capital in private equity funds, for example, can be locked up for years before investors receive distributions. When the global economy went into lockdown in 2020, this concern was brought into stark focus. Despite the market drawdown, cash was needed to meet benefit payments and spending needs, to cover capital calls stemming from prior commitments, to satisfy margin requirements from hedging positions or to pursue attractive investment opportunities arising from market dislocations. CIOs did not know how long the crisis would persist. A month or two was tolerable, but six months or a year? The lack of liquidity appeared to be a bigger threat than market volatility. Unlike fluctuations in returns, which tend to be transitory, having sufficient liquidity during a sustained downturn can be a matter of survival.

In addition to concerns about sustained liquidity drains, another difficulty of holding private assets is also related to their unique cash flow characteristics. Unlike investing in public assets, CIOs do not immediately gain the same amount of exposure as how much they commit to private assets. Building a *de novo* private portfolio or increasing an existing allocation is a gradual process. For example, private equity fund exposure increases over the first several years after commitment as capital is called, then gradually declines as distributions are paid. To achieve or maintain a target private asset allocation, CIOs need a commitment-pacing strategy that maps out future commitment amounts to steer total private portfolio exposure to a desired level. Meanwhile, cash inflows (distributions) and outflows (capital calls) need to be forecasted and monitored for their liquidity impact on the overall portfolio.

A multi-asset, multi-period cash-flow-based portfolio construction framework that brings liquidity risk to the forefront is needed to address these challenges of allocating to private assets. We provide a framework that combines three components – top-down asset allocation (*e.g.*, the mix of public stocks and bonds and private asset holdings), bottom-up private asset investing decisions (*e.g.*, private asset commitment history and pacing strategies) and portfolio liquidity demands – to form a complete understanding of the trade-off between portfolio liquidity risk and performance.

Such a framework helps CIOs gauge their portfolios' liquidity risk and whether allocating more (or less) to private assets helps (or hurts) their goal of enhancing portfolio performance while adequately managing liquidity risk. As a result of this analysis, a CIO may find they can comfortably take more liquidity risk, or that they are taking too much. But a framework helps them become comfortable with their portfolio allocation and pacing decisions.

CIOs need a framework combining three components – top-down asset allocation, bottom-up private asset investing decisions and portfolio liquidity demands – in order to form a complete understanding of the trade-off between their portfolio's liquidity risk and performance

The private equity industry has record amounts of dry powder with potentially fewer attractive investment opportunities in an increasingly crowded private market. Additionally, with growing concerns of inflation risk, central banks are looking to raise interest rates. The combined effect could shift CIOs' attention more towards future private asset performance. CIOs need to incorporate and update their views regarding future relative performance of private vs. public assets. Also, given the higher idiosyncratic risk of private assets, CIOs need to evaluate their fund-selection skill and adjust allocations accordingly.

CIOs can envisage other what-if scenarios to better prepare their portfolios for the uncertainties that lie ahead. For example, as funding ratios rise, some corporate DB plans considering de-risking could adjust their glidepath design to identify the desired allocation of private assets to balance the trade-off between portfolio performance, funding ratio volatility and liquidity risk.

As private markets continue gaining attention, we expect more innovations in this industry with respect to the funding vehicles (such as direct investment and co-investments), fee structure, secondary markets, to list just a few. CIOs need a versatile, customizable, and ever-developing asset allocation framework to help them harness the potential of private markets.

See J. Shen and M. Teng , '*Harnessing the Potential of Private Assets: A Framework for Institutional Portfolio Construction*,' PGIM IAS, June 2021.