



Adding return and lowering risk with private assets

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Private assets bring a number of advantages to portfolios, from return enhancement, to income, to reduced risk, to diversification via differentiated drivers of returns. But increased demand means investors should seek out less crowded markets. Access to deals and a focus on inefficient markets are critical to identifying attractive investment opportunities.



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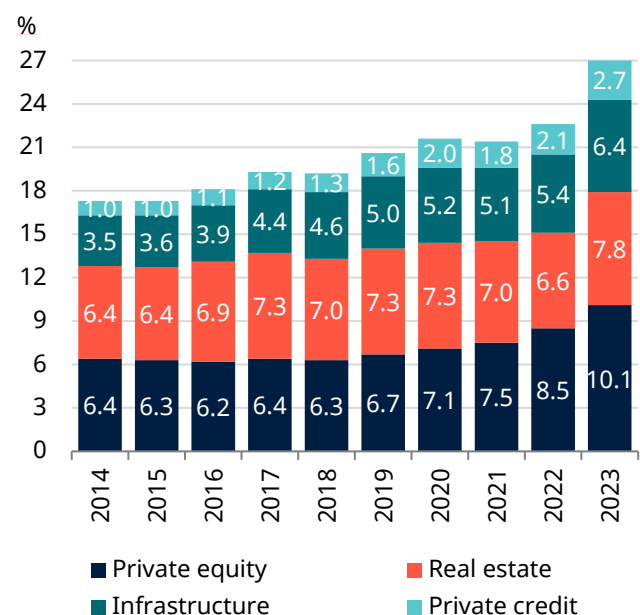
An expanding market

Assets under management across private assets – a comprehensive category that includes private equity, real estate, infrastructure, and private debt – soared from only \$700 billion in 2001, to \$3.1 trillion in 2011 reaching \$13.6 trillion in mid-2023. These markets are still small relative to the \$86 trillion market size of the combined public equity, corporate, and high yield bond markets, but they have been growing much faster. Their near-20-times increase in size dwarfs the three-times rise in the size of the global public equity and corporate bond markets over the same period. As this only covers funds, rather than separate mandates or individual investments, the true size of the private market universe is even larger. Private markets' growing scale means investors cannot afford to ignore them when making asset allocation decisions.

Demand has surged from both companies wanting to raise capital privately, and investors wanting to allocate more to the space. To date, much of this demand has come from institutional investors. The average institutional investor had 27% of its portfolio allocated to private assets at the start of 2023, a big rise from 17% a decade earlier (Figure 1). Allocations have risen across private equity, real estate, infrastructure, and private credit.

But access to the space is broadening further, with increased participation from high-net-worth individuals and retail investors. Regulatory developments and product innovation have paved the way.

Figure 1:
Average institutional allocations to private assets have risen



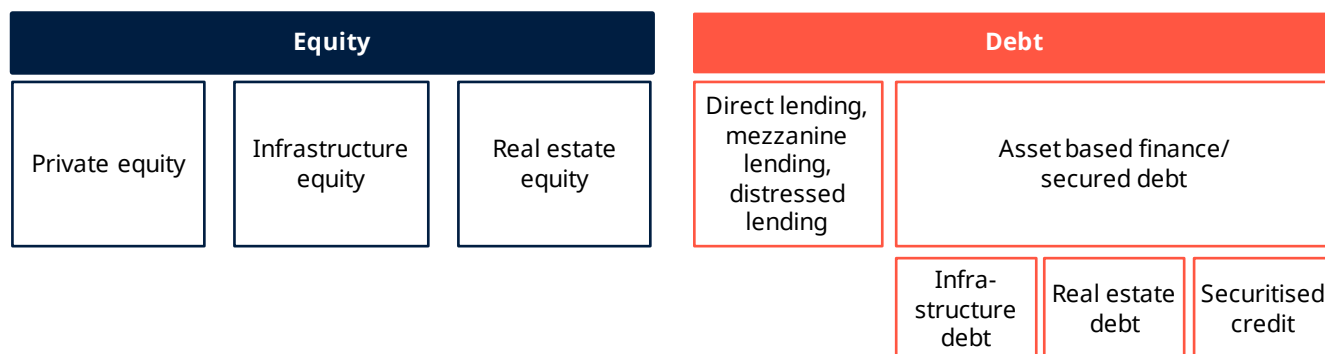
Source: McKinsey Global Private Markets Review 2024.

In this paper we analyse the main reasons why private assets appeal, digging behind the numbers to test the underlying rationales.

We cover the main categories of private assets, as set out in Figure 2, below. This list is not

Figure 2:

Private assets – the main categories



Source: Schroders.

A diverse universe

It is important to understand that private assets cover a wide range of investment opportunities. While this makes it difficult to generalise, it also provides investors with a diverse toolkit to choose from. Risk, return, and liquidity profiles vary significantly.

- Some assets offer the potential for higher returns, others offer greater certainty of returns, others less correlation to the economy and access to differentiated drivers of returns
- The traditional equity-debt split in public markets also exists in private markets. There are assets such as real estate, infrastructure, and corporate equity (private equity), and alongside those there is debt similarly across real assets, corporations and other commercial secured debts
- When people hear “private debt” they think first of corporate lending, or “direct lending”. Private corporate lending has grown materially over the last two decades and represents \$1.7 trillion, with senior direct lending about \$500 billion. This market has grown rapidly, both in size, and in capital raised, deployed and dry. This private market has grown alongside a syndicated market (leveraged loans and collateralised loan obligations) and competes with the syndicated market to some degree

exhaustive, and a comprehensive analysis of the entire spectrum is beyond the scope of this paper. Nevertheless, the principles and arguments presented can be applied to a wider range of private assets.

- As direct lending has become a larger allocation and a more mature market, the evolution within debt has been to diversify to other types of lending, including asset-based finance. This market has captured attention owing to its diversity and larger scale. It includes more than \$13 trillion across secured debts such as commercial real estate debt, infrastructure debt, consumer debt (auto loans, credit cards, student loans, etc), and receivables or lease finance
- The income generation in the private or non-syndicated debt markets¹ can also include contingent cashflows and risk transfer, further enhancing the options to create income solutions. Some of these markets are well-established, while others are still developing
- Each of the categories in private assets can be broken down into subsectors that have distinct fundamental factors and investment characteristics. Private equity alone can be broken down into venture capital, small/mid/large buyout, growth, turnaround, secondaries and more. Commercial real estate and infrastructure are traditionally split into core, core plus, value-add and opportunistic
- As far as private debt is concerned, the distinction of debt as being repaid by general corporate cashflow or by the cashflows secured by critical assets, or operating assets, is also an important distinction. Common distinctions are also made between senior,

¹Syndicated loans involve multiple lenders collectively providing funds to a borrower. This contrasts with direct

lending and other types of private debt where there is only a single lender. Leveraged loans are an example of a syndicated loan.

mezzanine or unitranche/whole loans, as well as by credit quality (rating). But there is also a wide range of terms including tenor (maturity), and fixed, floating or floored coupons

Liquidity

A key feature of private assets is their illiquidity, meaning they are not as easy to buy or sell as their public counterparts. Liquidity can vary significantly across different assets/investments and the different vehicles/fund-structures that invest in them.

On the vehicle side, a traditional, closed-ended, private equity fund could have a ten-year life; a semi-liquid fund – a relatively new way to invest that is gaining traction – could allow investors to put money in once a month and withdraw once a quarter (this varies); investment trusts and real estate investment trusts (REITs) offer daily trading.

This is different from the liquidity of the underlying investments. For example, a loan to an infrastructure project could last decades, whereas a loan to a company could be repaid in three to five years.

This distinction can easily be seen in the least liquid of the structures too, like the traditional closed-ended structure. Although a closed-ended fund could have a ten-year life, this can be broken down into a number of different phases. It will often include a period during which capital is committed

to it, but not yet drawn down (when it can be invested elsewhere but may be called on at short notice), a period when capital is drawn down and invested, and then a divestment period, when assets are sold or debt matures and the proceeds are distributed to investors. The result is that capital is not tied up for the entire life of the vehicle.

For example, for private equity buyout funds, which typically have a life of seven to ten years, individual tranches of capital will generally only be drawn down for an average of three to seven years at a time. It is in this second period that the investment is truly illiquid.

Given the diversity of investments on offer, it is rare to find an investor whose portfolio would not benefit from exposure to at least one part of the private universe.

Figure 3 shows a summary of the main investment categories within the private assets, with publicly-traded equities, corporate bonds and high-yield debt included for comparison purposes. Further details on these will be examined later in this paper.

Figure 3:

A bird's eye view of the private asset landscape

	Holding period of underlying investments (years)	USD yield (%)	Typical credit spread (%)	Extent of investor control	High potential returns	Stable income generating	Security	Low risk of capital loss (single investment)	Low risk of capital loss (portfolio)	Equity diversifier	Government bond diversifier	
Equity	Global equities	Daily liquidity	2-3	n/a	✓	✓✓	✗	✗✗	✗✗	✗✗	✗✗	✓✓
	PE: large buyout	4-7	n/a	n/a	✓✓	✓✓	✗✗	✗✗	✗✗	✗✗	✗✗	✓
	PE: small/mid buyout	4-7	n/a	n/a	✓✓	✓✓	✗✗	✗✗	✗	✗	✓	✓✓
	PE: venture	5-8	n/a	n/a	✓✓	✓✓	✗✗	✗✗	✗✗	✗	✓✓	✓✓
	Infra equity	10+	5-8	n/a	✓✓	✓	✓	✗	✗	✗	✓	✓
	Real estate	4-6	6-7	n/a	✓✓	✓	✓✓	✗	✗	✗	✓	✓
Debt	IG corporate bonds	Daily liquidity	5-6	1.0-1.5	✗✗	✗✗	✓✓	✗	✓✓	✓✓	✓✓	✗✗
	Securitised credit ¹	varies	7-11+	2-6+	✓	✓✓	✓✓	✓✓	✓	✓	✓✓	✓✓
	Senior infra debt	10+	7-8	2-3	✓	✗✗	✓✓	✓✓	✓✓	✓✓	✓✓	✗✗
	Senior real estate debt ¹	5-7	7-8	2-3	✓	✗✗	✓✓	✓✓	✓✓	✓✓	✓✓	✓✓
	High yield debt	Daily liquidity	7-9	3-6	✗✗	✓	✓	✗✗	✗	✗	✓	✓
	Junior infra debt [*]	5	9-11	4-6	✓	✓	✓✓	✓	✓	✓	✓✓	✓✓
	Mid-market direct lending ¹	3	9-11	4-6	✓	✓	✓	✓	✓	✓	✓✓	✓✓

Sources: ICE Data Indices, LSEG Datastream, MSCI, and Schroders. ¹Typically, floating rate debt, paying a coupon which increases with interest rates. Capital losses.

Categories above are not exhaustive and are shown for illustrative purposes only. Infra = infrastructure, IG = investment grade. Although they do not normally have a formal credit rating, senior infrastructure debt and senior real estate debt share characteristics with investment grade corporate bonds, in terms of credit quality. Similarly, junior infrastructure debt and mid-market lending share characteristics with high yield (sub-investment grade) debt. Securitised credit spans investment grade and sub-investment grade.

1. Why private assets?

There are five key ways in which private assets can potentially add value:

- 1.1 Provide higher returns/income
- 1.2 Provide access to a broader range of exposures, industries or outcomes
- 1.3 Reduce risk (volatility and/or risk of loss)
- 1.4 Add diversification benefits by introducing differentiated drivers of returns (as well as traditional statistical measures of diversification)
- 1.5 Provide more direct exposure to impact investing

1.1 Higher returns

An attraction of private assets is their ability to earn a higher return than their public equivalents. As shown in the first two charts of Figure 4, private equity has handsomely outperformed public equity over time and private infrastructure has outperformed public infrastructure. Attention is often focused on the higher fees charged by private asset investment managers, but these results are net of all fees.

In the fixed income world, private debt commands a yield premium over public markets without the need to take on additional credit risk, as highlighted in Figure 6.

Real estate's experience is more mixed. Listed real estate investment trusts (REITs) have actually outperformed private funds over the long run (Figure 4, bottom), although this can be explained by the higher leverage in REITs.

A large part of the return pick-up in private assets arises because they are cheaper to buy than public ones. Figures 5 and 6 show this over time for private equity² and infrastructure debt. The reason is clear. Let us say an investor is offered two potential investments, both identical other than the fact that one can be sold easily and the other ties up money for five years. They would want to pay less for the one with poorer liquidity. That cheapness can result in an *illiquidity premium*, a reduction in the price or additional yield to compensate for having money tied up.

In reality, the magnitude of the additional return offered by private assets is not solely due to illiquidity but also to other factors like transaction size, complexity and the deal sourcing ability of an

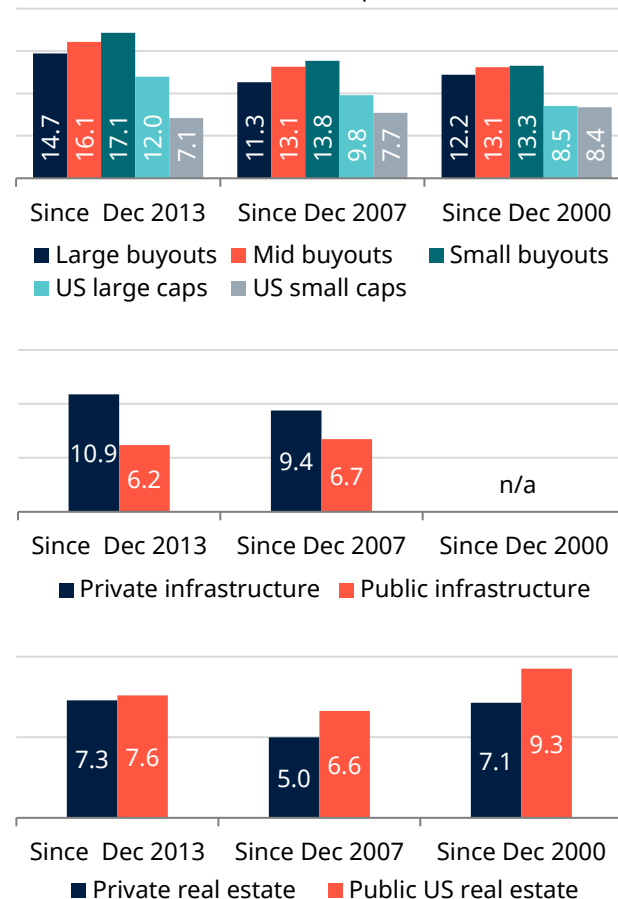
investment manager. In most cases, it is impossible to disentangle these different drivers, but it is important to be aware of their existence.

"Complexity premium" would be a more appropriate description than illiquidity premium, in fact.

Deal sourcing is an often under-appreciated factor which can make a big difference to an investor's experience in private assets. In general terms, the more competitive the bidding process, the higher the price paid and the lower the expected return. Deals sourced through private networks of contacts can be completed with far less, or even no, competition.

Figure 4:
Private assets typically outperform, net of fees

Returns to 31 December 2023, p.a.



Sources: LSEG Datastream, NCREIF, Preqin, and Schroders. US large cap is S&P 500 index; US small cap is Russell 2000 index; public infrastructure equity is Dow Jones Brookfield Global Infrastructure index; public real estate is MSCI USA REIT index; private equity and private infrastructure are Preqin quarterly (pooled fund) indices; private real estate is NCREIF Fund Index - Open End Diversified Core Equity Fund Index. All figures are total returns and private asset returns are net of fees.

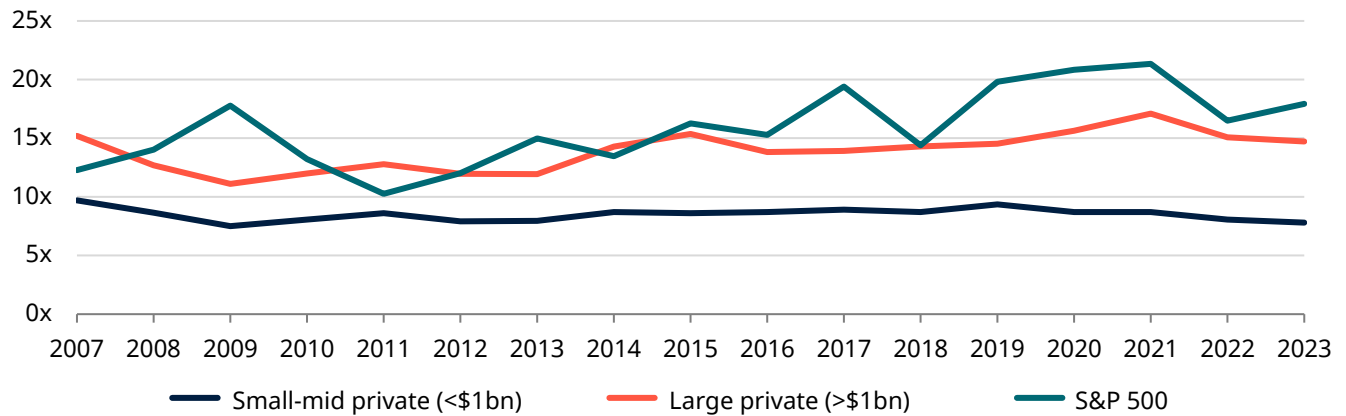
²A comparison has been shown with the average S&P 500 company, but small-mid buyout multiples are also at a

significant discount to small cap public equities, such as the average S&P 600 company. The average discount over the 15 years to 2023 has been 53%.

Figure 5:

Private companies are cheaper than public

Average EV/EBITDA¹ buyout multiples vs. S&P 500

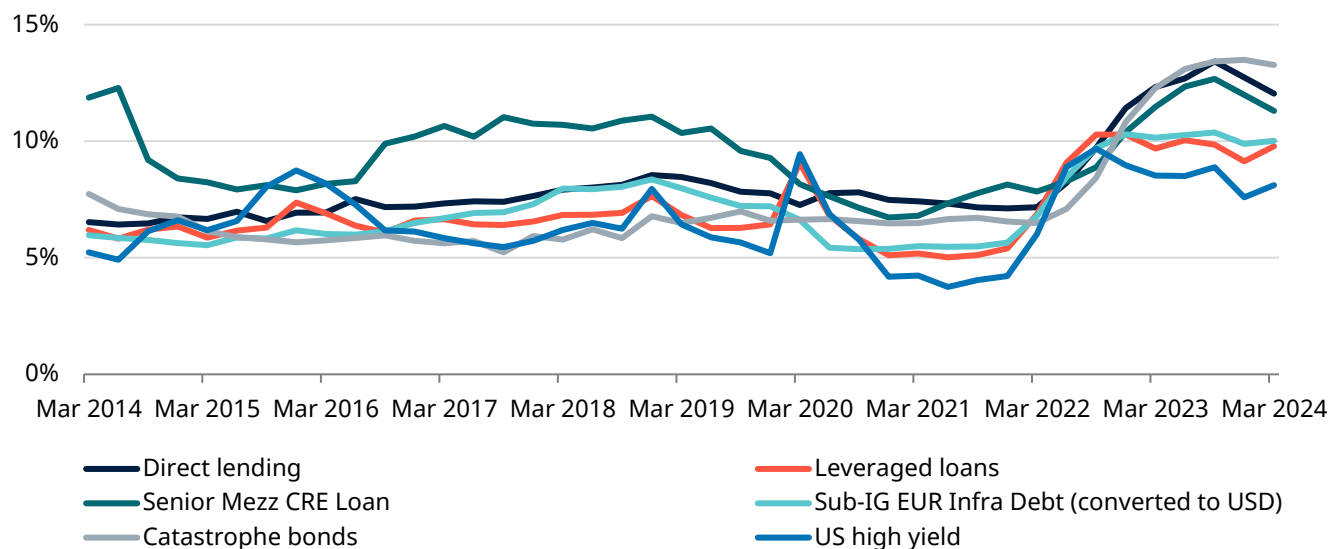


Source: Baird Global Investment Banking, S&P Capital IQ, S&P. ¹EV = enterprise value = the total value of a company, taking account of equity and net debt. EBITDA = earnings before interest, tax, depreciation and amortisation.

Figure 6:

Private debt offers a yield pick-up over public bonds such as high yield debt

USD yield



Source: Bloomberg, Schroders.

This “deal-sourcing alpha” is a feature across much of the private asset universe. Managers with existing relationships have a competitive advantage, a barrier to entry for newer participants as it takes time to establish credibility. One complaint sometimes levied against private assets is the time it takes to deploy capital but here too, the better access to deals of more experienced practitioners gives them an edge.

As well as being potentially cheaper (e.g., figures 5 and 6), investment managers in private markets have more levers at their disposal to improve returns (Figure 7) than in public markets. They are much more hands-on than their public equivalents and have access to a wider range of information in

a timelier manner than is possible in public markets. Private equity general partners routinely influence corporate strategy and appoint directors and management. Real estate managers actively manage lease extensions and building refurbishments. Private debt managers negotiate covenants and security packages, which give them greater protection than would be standard in corporate bonds. In some cases, these give them the right to step in and direct strategy if a borrower is struggling.

Figure 7:

Sources of added value

Factor	Source of add value	Public market	Private market
Market timing	Deciding appropriate entry/exit point	✓	✓
Stock selection	Identifying most attractive opportunities	✓	✓
Negotiations	Ability to negotiate attractive entry price/conditions	✗	✓
Operational improvement	“Hands-on” approach with ability to effect change	~	✓
Leverage	Ability to boost equity returns and instil financial discipline at portfolio companies	~ ¹	✓

Source: Schroders. ¹The ability of public market investors to influence a company's capital structure is more limited than in private equity. The efforts of activist investors are the main exception. Individual investors can borrow to invest in the stock market, but the additional risks associated with this strategy, including the need to make margin payments, mean that this is relatively uncommon.

The private debt return advantage

Private debt is all about income. Depending on the subsector, structure, and investor preference, this income could be defensive, uncorrelated, opportunistic, or low-volatility (see below). In each case, a primary appeal is its ability to earn a return premium over public corporate or high yield bonds.

In addition, the income-driven return profile of private debt can serve as a powerful complement to investments with a more back-ended total return profile, such as private equity. Plus, with many private debt investments being floating rate, their income yields rise when interest rates rise. This contrasts with traditional corporate bonds whose coupons are fixed.

Defensive income: infrastructure debt benefits from cash flow stability.

Uncorrelated income: private debt can provide exposure to sources of income that are fundamentally different to traditional asset classes such as corporate bonds. The income from asset-based finance depends on the cashflows of an asset, not corporate risk.

An even stronger example are insurance-linked securities (ILS). Although not covered in detail in this paper, the income from these depends on the occurrence of insured events, such as natural catastrophes. As these are not influenced by market fluctuations, economic conditions, or corporate factors, they can act as a fantastic diversifier. Catastrophe bonds are publicly traded but a large part of the market is private.

Opportunistic income: with the Basel III tighter banking regulations, and changing fundamentals, there has been a notable pull-back in bank-

provided financing for real estate. Debt investors focussed on strong markets and strong sectors, can find higher-quality loans on lower loan-to-value ratios (LTVs), owing to the impact of the reduced footprint of the regulated banks.

Low volatility income: with higher interest rates, the ability of a borrower or a project to cover interest is critical. The market has more exposure to idiosyncratic, issuer-specific, risk in this regard. This is a key advantage of asset-backed securities or asset-based finance. These investments are secured and pooled. The security is diverse and remote from the risk of the borrower.

Importantly, for secured debt, in the event of a default, an asset or assets can be sold, and the proceeds are used to repay the lender. This boosts recovery rates and limits losses. For example, recovery rates for infrastructure and real estate debt have averaged around 75%, substantially more than the 40% level typical of corporate bonds. Historically, the most common recovery rate on infrastructure defaults has been 100%.

Direct lending is not typically backed by ring-fenced assets, but is often senior in the capital structure and subject to tighter lender oversight. This oversight takes the form of borrowing covenants which provide lenders with a stronger degree of control in the event that the company's financial condition deteriorates over the life of the loan. These factors have historically driven lower loss rates for direct lending relative to high yield bonds and leveraged loans.

Higher, more certain returns make private debt an excellent fit for many investors.

Investors should be aware, however, that default and recovery rates can range based on sector and fundamental factors. In today's market, not all recoveries will be as high as historical averages. This is more likely to be a risk in areas where there has been weakness in lending standards, such as looser or non-existent covenants. Direct lending is

1.2 Access to a broader range of exposures, industries, or outcomes

For certain assets, the public market captures only a small subset of the overall market. In 1996 there were over 2,700 companies on the main market of the London Stock Exchange. At the end of 2023 this had collapsed to less than 1,100 – a 60% reduction.

The figures look even worse when viewed over a longer time frame. There has been a 75% fall in the number of UK-listed companies since the 1960s (Figure 8).

Europe's downturn started later, but Germany has shed nearly 50% of its public companies since 2007.

Even the US, often admired from afar, has experienced a 47% drop since 1996. This is even after allowing for the US boom in initial public offerings (IPOs) in 2021.

In the US, over 300 companies a year, on average, joined the stock market between 1980 and 1999. Since then, there have been only 127 a year. Other markets are mostly worse. Alongside a lack of new

the most obvious example and stands in contrast to the more robust lender protections underpinning asset-based finance. This highlights the benefit of looking across debt, to pivot capital deployment to the debt sectors that benefit most from fundamentals and where inefficiency offers excess returns.

entrants, M&A-driven de-listings have consistently reduced the stock of existing companies on the public market.

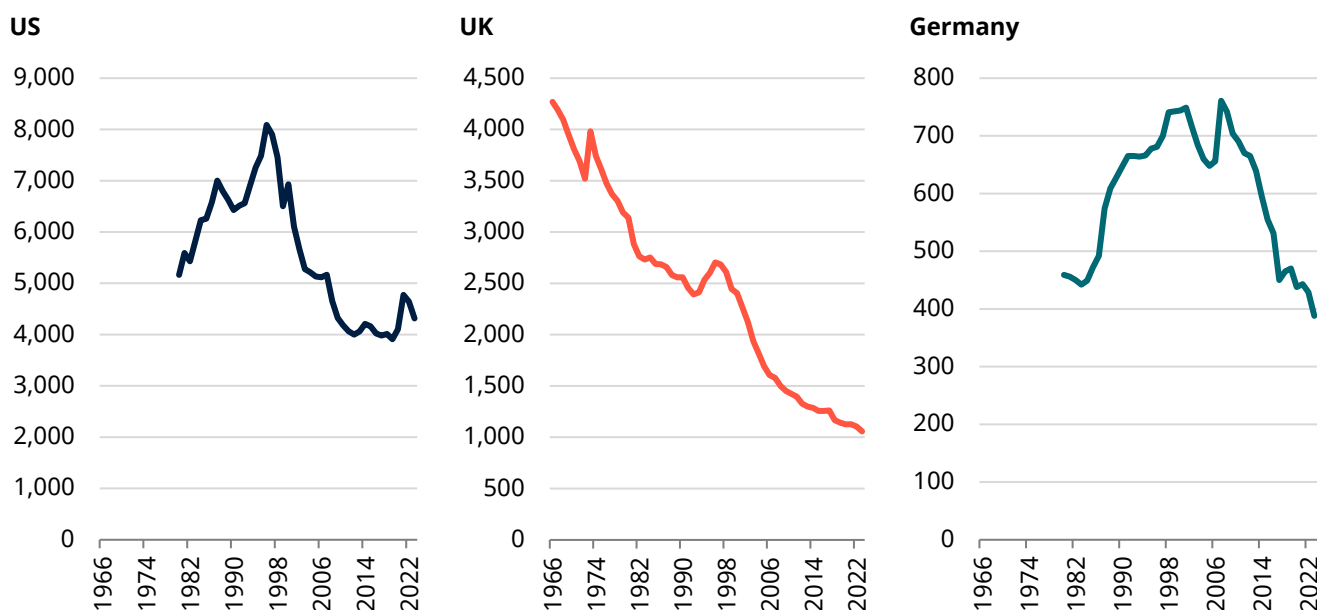
Companies are put off a stock market listing by the perceived increased cost and hassle of being a public company, alongside the increased ability to raise money from today's greatly enlarged private equity industry. Private equity can now finance companies to a much later stage of their development than in the past. Multi-billion-dollar financing rounds are not unusual. Previously, only the public market could have delivered on that. From a company's perspective, the cost-benefit analysis has shifted toward private markets.

The stock market now provides exposure to a dwindling part of the corporate universe. Fewer than 15% of US companies with revenue over \$100 million are listed on the stock market. 85% are held privately (Figure 9). In Europe it is even more extreme. More than 95% of companies with revenues greater than \$100 million are private businesses.

Figure 8:

Far fewer companies are listed on major stock markets than in the past

Number of public companies



Source: LSEG Datastream, Schroders, World Bank Development Indicators, and World Federation of Exchanges. UK data is for main market of the London Stock Exchange only. December 2023.

1.3 Lower risk

Measuring and understanding risk in private assets is challenging:

- Valuation methodologies may smooth reported price variability
- Investors are often unable to sell their investments quickly, so it is questionable whether standard analyses of month-to-month price movements even have any relevance

When the volatility of private assets is calculated in the traditional way, as standard deviation of historical monthly or quarterly returns, many private assets appear relatively low risk. This feature can be appealing to investors who are concerned about the reported volatility of their portfolio. For example, it can limit the impact of changing asset valuations on a company's pension expense in its profit and loss account. In such an instance, the stability of private assets is highly prized.

However, while there can be fundamental reasons why certain private assets could be considered lower risk than their public peers (see later), this is also partly a consequence of their valuation methodology. Many private asset valuations are updated infrequently, if at all, and are not always tested against public market prices ("marked to market"). Both features dampen volatility.

While this practice remains widespread, not all private asset classes or structures exhibit it. For example, the assets in semi-liquid funds are valued monthly or quarterly in accordance with rigorous accounting standards, such as US GAAP and IFRS 13. To ensure these valuations provide an accurate picture of the fund's holdings, they are often audited by reputable audit firms and regularly reviewed by internal pricing committees.

Approaches taken to remedy the "smoothed volatility" problem include extending the time period used for returns when calculating volatility (e.g. using annual returns rather than quarterly returns) or employing statistical de-smoothing techniques.

The former can make a difference, as it is more common for some assets to be revalued fully on an annual basis, rather than every quarter. This removes some distorting effects.

The latter is a statistical technique that attempts to add back the volatility that is dampened by stale valuations. It can make a useful contribution to any analysis of private asset risk but, while commonly used, should not be relied upon in isolation. Some of the underlying assumptions can be challenged as unrealistic⁴ and it is very sensitive to both the data period and model used. For example, when we de-smooth US core real estate returns, the model suggests that US core real estate fell in value by 68% in the final quarter of 2008 and a further 29% in the next quarter. While the US real estate market clearly suffered a sharp decline over this period, it did not lose over three quarters of its value in six months (other than perhaps for some distressed sellers). In our analysis, we remove these two quarters when calculating volatility. The fact we have been forced to do so demonstrates the vulnerability of this approach.

Figure 11 sets out the volatility of real estate, buyouts and venture capital on a quarterly, annual and de-smoothed basis. It shows the divergent results under these different approaches. Both annual and de-smoothed volatilities are higher than the traditional analysis of quarterly returns would suggest, in some cases, much higher. This highlights the limitations of relying on short-term return analysis as a measure of underlying risk.

For private equity, we have shown venture capital over the whole period and an alternative, which excludes 1999–2002. We do this as the extreme nature of the Dotcom bubble has a big impact on calculations of volatility, but is perhaps less meaningful on an ongoing basis. Venture returned 300% in 1999 alone, for example, making 2021's 62% rise look modest in comparison. Other periods are less anomalous.

It is interesting to note that, even based on annual returns, buyouts appear less risky than public equities, despite their higher leverage. Venture capital volatility is only roughly on a par with small caps, despite some of the investments being in much earlier-stage, higher-risk companies.

This highlights that, while any individual venture capital investment is very risky, the risk is mitigated when several investments are put together in a portfolio. Each can perform very differently, driving significant diversification benefits at the overall portfolio level.

⁴Such as the assumption that the quarterly net asset values are actual market values that an investor could buy and sell,

which is not the case for private equity. The results could give an investor a misleading view of their investment.

Figure 11:

Standard approaches can understate volatility

	Volatility of quarterly returns	Volatility of annual returns	Volatility of de-smoothed quarterly returns
US core real estate	6	10	12 ¹
US buyouts	11	16	16
US venture	21	54	29
US venture ex-1999–2002	12	20	16
US large caps	16	18	n/a
US small caps	21	19	n/a

¹De-smoothed volatility for core real estate excluding the period from the fourth quarter 2008 to the first quarter 2009.

No de-smoothed volatilities have been shown for large or small cap public equities, as statistical tests do not indicate the presence of any smoothing in these return series. Given the liquidity of public markets, this is to be expected.

Core real estate is NCREIF Open-Ended Diversified Core Real Estate Fund index; buyout and venture data are quarterly returns; All data covers Q1 1990-Q4 2023. Source: Burgiss, MSCI, NCREIF and LSEG Datastream.

Any attempt to analyse the volatility of private debt comes up against material issues. First, there are different methods applied. Some (including Schrodgers) are fully, independently, marked-to-market using prevailing market yields, others value at cost-less-impairment, and others use discounted cash flow style approaches. Second, there is not the same depth of data on fund returns that exists for real estate and private equity. Volatility can be inferred by comparison with broadly syndicated leveraged loans, but this can misstate risk given that private debt can benefit from covenants and security less typical in syndicated corporate loan markets. Private debt rarely has a formal credit rating so any such analysis relies on estimates, and methodologies may vary. Both junior infrastructure debt and much of direct lending are categorised as sub-investment grade (high yield). However, infrastructure assets generate stable cash flows, where the debt is backed by hard assets with long economic lives. This should result in it being given a more favourable risk assessment.

At a higher level, there are a number of fundamental drivers of risk that can be qualitatively appreciated (all else being equal):

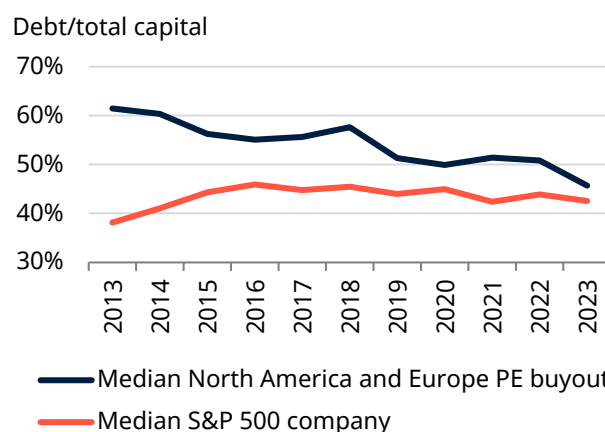
- Real estate leases normally run for several years and often have some form of indexation or upward-only rent clause, which prevents downward adjustments during the term of the lease. This provides a more stable

underpinning to returns than in public equities

- The cashflows from infrastructure projects are less sensitive to the economic cycle than the broader equity market
- For a given asset, a more leveraged investment is riskier than a less leveraged one. Buyouts are more highly leveraged than public markets so are riskier from this perspective (albeit there tends to be a focus on industries where there are recurring revenues, and which are less cyclical e.g., healthcare and tech as opposed to industrials or financials). But deal structures have become steadily more conservative on this front over the past decade (Figure 12). Ten years ago, the average buyout was more than 60% debt-financed. In 2023 that had fallen to 46%. Sponsors are putting in bigger equity stakes than in the past. That 46% is barely more than the 43% debt-financing in the median S&P 500 company (with the caveat that the S&P 500 figure is based on the accounting/book value of companies, which will be lower than market value). This latest decline is also a function of debt becoming more expensive and less appealing than it was for the previous decade

Figure 12:

Private equity-backed firms have been reducing their reliance on debt



Source: LSEG Datastream, Pitchbook, Schrodgers.

- By the same argument, not all private equity buyouts are riskier than public markets. Small and mid-cap buyouts are less highly leveraged, and some other strategies employ little or no leverage at all.
- Individual funds of private assets are less diversified than public market funds and so are riskier from this perspective. However, this risk can be mitigated at the portfolio level by

spreading investments across a number of funds over time and/or by investing in funds of funds

- The controlling stakes that private equity investors typically take in their portfolio companies afford them more access to information in a timelier manner than would be possible in public markets. This ability to do much deeper due diligence helps to mitigate the risk of any individual investment and thereby avoid unwelcome surprises
- Some of the price movements in public markets, and by consequence volatility, are driven by investor fear and greed rather than underlying fundamentals. The behavioural temptation to sell when markets are falling is in itself a contributor to volatility. The fact that investors in private assets are often unable to sell their stakes in such an environment prevents them from making the same behavioural mistakes and insulates private assets from these sentiment shocks. Instead, it plays to their advantage as it allows private asset investment managers to act in a counter-cyclical way. Arguably these short-term shifts in sentiment are irrelevant to the long-term investor. The fact that they are glossed over in private asset volatility should not necessarily be misinterpreted as an oversight or “wrong”

Notwithstanding the desire to fit private assets into a traditional risk/return framework that allows easy comparison with other asset classes, a bigger question is whether volatility is really the right measure for investors in private assets to be looking at? It measures how bumpy the ride is, but that is somewhat meaningless if a private asset investor is committed to invest for the long run.

Therefore, a more holistic approach to understanding risk is required. Real estate risk is nearer to equities than bonds, despite what standard volatility analysis might suggest. Private equity is highly diverse. The slightly higher leverage in large cap buyouts means that it would be reasonable to treat the sector as riskier than public equities, but a qualitative case can be made for small and mid-cap buyouts to be given more favourable treatment. Individual venture capital investments may be risky, but portfolios have been remarkably resilient and can also gain in value even when markets are crashing. Private debt too is highly diverse. There are elements that are less risky than corporate bonds, but the spectrum is wide.

Cashflow stability is a subject we intend to return to in more detail in subsequent research.

Figure 13:

Private assets have different underlying risks to public markets

Cashflow stability	Asset-backing/security	Investor protections/covenants	Superior access to information for active manager	Long term nature shields from short term noise
Illiquidity	Leverage	More limited valuation transparency for end investor	Concentrated individual funds	Elevated performance dispersion between funds

Source: Schroders.

1.4 Diversification benefits

Given their differing underlying exposures and return drivers, private assets offer diversification benefits compared to public markets. These vary by asset class and market.

However, valuations can often be slow to update and/or unreliable, so standard correlation analysis risks overstating these benefits and understating the underlying economic linkages. This is similar to the issues with volatility described earlier.

But, as already argued, private assets can provide exposure to different asset classes and return drivers to public markets. Diversification potential is a natural consequence.

A better way to consider the relationship between public and private returns is to look through to the underlying exposures and focus on differentiated drivers of returns, not statistical estimates of correlation. Figure 14 provides indicative guidance about the relative strength of relationship that

various private assets have with returns from public equity and government bond markets.

For private equity, the relationship with public markets varies significantly by sector. Large buyouts returns are strongly influenced by public markets. However, the relationship is much weaker elsewhere. Early-stage venture capital depends less on stock markets and the economy (as companies typically have no or low revenues and no earnings), but on progress in product development and initial customer wins. This can also be true of more mature venture capital. Some companies in the private equity “growth” sector grow strongly not because of strength in their underlying markets, but because of disruption and taking business trade away from incumbent industries – something which could even accelerate in a down market.

Similar variations exist in real estate and infrastructure. For example, the greater stability of infrastructure cashflows and the lack of sensitivity that certain sectors have to the economic cycle (especially government-backed projects) can drive diversification benefits for investors in those sectors. In contrast, other sectors, such as (sea) ports, are heavily influenced by global trade and are consequently less-effective diversifiers.

Turning to the relationship with government bonds, an environment of rising bond yields and falling (possibly negative) government bond returns would also hit fixed-rate, senior infrastructure debt, at least on a mark-to-market or mark-to-model basis. Although higher interest rates would normally be associated with an improving economic climate, which is supportive

for equity investments, higher borrowing costs would be a drag on returns for more leveraged equity investments. These might include infrastructure, large buyouts and value-add/opportunistic real estate.

In contrast, equity investments with little or no leverage would be less directly affected.

The floating rate nature of much private debt also means that higher interest rates feed directly into higher returns, whereas higher rates lead to falling prices of traditional fixed rate government and corporate bonds. This makes much of private debt a fantastic stabiliser when volatility is coming from interest rates, and a beneficial partner to traditional fixed income exposure.

Whereas direct lending has a similar risk sensitivity to corporate bonds (aka corporate risk premium), asset-backed lending such as real estate and infrastructure debt, and consumer lending has exposure to the underlying cashflows from an asset or package of assets, so it is fundamentally different.

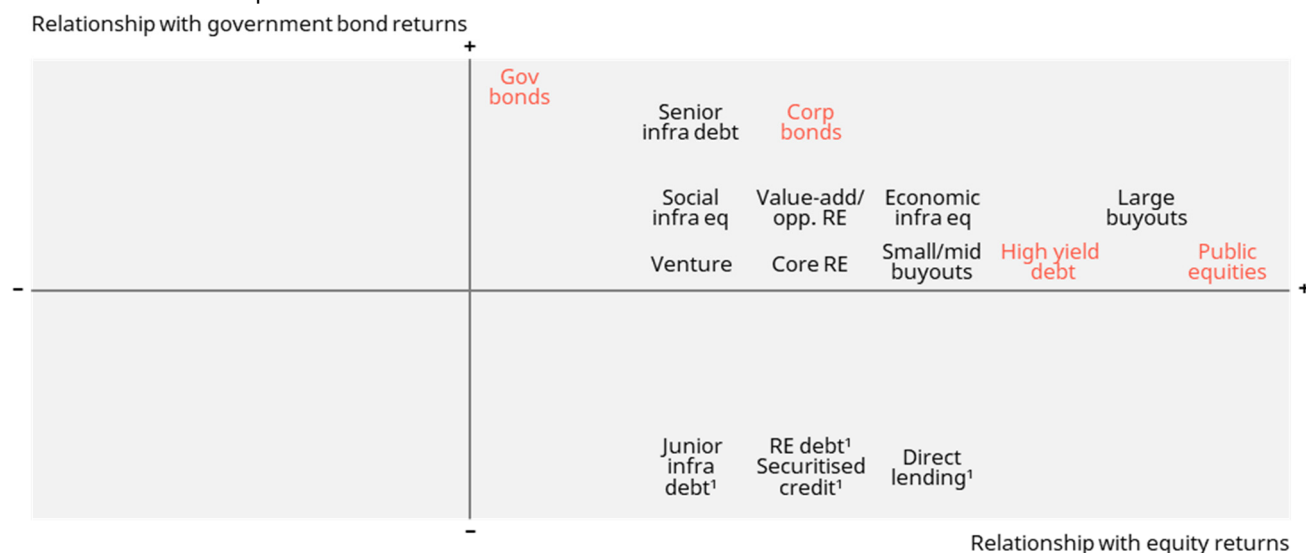
Another source of returns is through the direct action of private asset managers in sectors where they adopt a hands-on approach. This too, can lead to returns that diverge from the broader market.

In summary, the ability of private assets to diversify existing public investments can be a major attraction, but attention must be paid to the underlying exposures, as correlation estimates can be unreliable. Differentiated sources of return should take precedence over statistics.

Figure 14:

Sensitivity to public equity and bond markets varies by sector

Illustrative relationships



Source: Schroders. ¹Typically, floating rate debt, paying a coupon which adjusts to moves in interest rates.

1.5 Provide more direct exposure to impact investing

In recent years, an increasing number of investors have become focussed on the impact they have with their investments. Private markets offer distinct advantages for creating and measuring impact in a more precise manner than is possible in public markets.

In private equity, for example, significant equity stakes and board representation grant investors the ability to directly influence a company's trajectory. Where appropriate, this close connection can allow investors to align their investments with specific impact goals, such as the UN Sustainable Development Goals (SDGs). Private assets, particularly in sectors like renewable energy, affordable housing, and sustainable agriculture, have a direct link to these impact objectives.

For real estate, place-based impact investing (PBII) has a focus on outcomes like job creation and improved housing.

The patient nature of private market investing, with its long-term investment horizons, allows for positive change without compromising financial returns.

On the debt side, a clear example of the alignment of investments with impact is microfinancing, whereby microfinance institutions provide loans and (increasingly) savings, insurance and related products to groups with low-income, as well as micro, small and medium enterprises. These enable income-generating activities and help people to break out of poverty.

Private assets managers also benefit from direct engagement in impact measurement, particularly with unlisted companies that have greater accountability to investors. Data collection comes through direct interactions, which ensure the necessary information is obtained in a transparent manner.

In contrast, investors in listed companies face challenges in demonstrating the direct impact of their actions. While tools like engagement and shareholder voting can influence management decisions, it is often difficult to ascertain the extent to which individual actions drive outcomes, especially considering the large number of shares in circulation and the complex dynamics of the market. Standardised reporting also provides less "colour" than the information available to private asset investors.

2. Practical considerations

Increased interest in private assets has led to large amounts of capital being raised in the past decade. "Dry powder," money raised but not yet invested, has hit record highs. High fundraising runs the risk of too much money chasing the same deals, higher prices being paid, and lower future returns. Large buyouts and direct lending are two of the hottest spots on this front.

Better opportunities can be found by seeking out less crowded markets, and by using the credibility and reputation of an investment manager to gain access to deals that others would not see. Deal access has become one of the most important edges that a successful investor can lay claim to.

In addition, bigger transactions tend to be highly competitive, whereas smaller or more complex deals tend to be less so. An obvious example is a comparison between a private equity fund taking a public company private (by paying a premium to its public value) and a buyout of a family-run business with no other suitors.

In private debt, structuring is an essential skill, which presents a barrier to entry. This is especially true when dealing in less crowded areas where structure means more than just covenants. It may mean "matched term financing" or "Special Purpose Vehicles" or "tax blockers". Anyone can buy a corporate bond, but not everyone can draft, understand, and negotiate complex legal agreements.

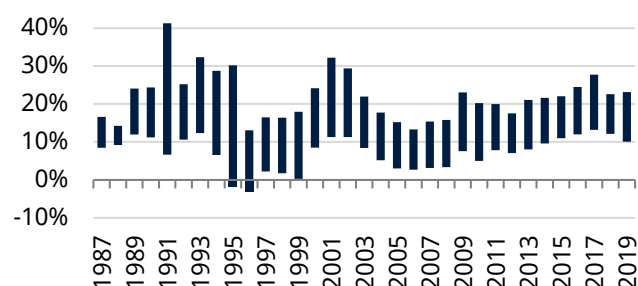
At this stage of the cycle, investors need to be more discerning about where and with whom they invest their money. Attractive investment opportunities can be found, but only if approached in the right way.

One consequence of the greater scope for private asset managers to steer their investments is a wider dispersion of returns than is typical in public markets. The difference in return between top and bottom quartile buyout funds globally has been around 15%, on average. Manager selection is more important when investing in private assets.

Figure 15:

The importance of fund selection in private assets

Interquartile range for net internal rates of returns from global private equity buyout funds, by vintage year, %



Source: Cambridge Associates.

Data to Q4 2023. More recent vintages have been excluded as it typically takes five years for a buyout portfolio to develop.

However, investing in private assets does introduce some fresh challenges. The cashflow profile of an investor's liabilities has implications for the amount they can afford to invest in illiquid assets. This is mainly an issue for investors with very large allocations and/or those who are highly leveraged – who may be forced to sell assets quickly to meet margin calls, as happened with the UK gilt crisis in 2022. In our experience, many investors have greater capacity to invest in illiquid assets than they realise. In addition, private debt, infrastructure and real estate equity are all highly cash generative and can be used to help meet cashflow liabilities.

Historically, investors who need more regular liquidity have found it more challenging to access private assets. However, structures such as interval and tender funds in the US, European Long-Term Investment Funds (ELTIFs), Long-Term Asset Funds (LTAFs) in the UK and semi-liquid funds in many other countries are breaking down these barriers.

A second element of liquidity management is the practical issues of managing withdrawals of capital and further investments to ensure exposure to the asset class is maintained, if desired. It can take several years for money to be drawn down for investment, depending on how quickly an investment manager can identify opportunities. Decisions must be made about how committed capital is invested in the interim to ensure it is available when called upon, without detracting from an investor's overall objectives. Assuming an investor wants to maintain exposure over time, they will also need to manage an ongoing investment programme across vintages. If not, their allocation will decline as they receive the proceeds from equity sales or maturing debt. A detailed discussion of these topics is outside the scope of this paper, but they should be carefully considered before an investment in private assets is undertaken. We will be covering them in greater detail in a separate article.

Conclusion

Private markets offer a rich variety of investment options which can diversify and enhance risk and return for investors. With their growing clout, more and more financing is taking place privately. Investors focussed solely on public markets risk missing out. There is no shortage of attractive opportunities, but, with increased interest has come increased competition. Investors should seek out less crowded markets to benefit from the return and risk enhancement that private assets can offer.

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