

Alt Goes Mainstream Unscripted Podcast

Transcript

Guests: MSCI, Luke Flemmer

Intro Music: Everybody gets a piece. We're going mainstream. Everybody's gonna eat. We're going mainstream. All my family sings. See you on mainstream. We're going mainstream. From Wall Street to Melrose Avenue. Venture capitalists, to athletes, to creators. To the person who's collected trading cards. In a collision of culture and finance. We're going mainstream!

Michael

Look, welcome to the Alt Goes Mainstream podcast.

Good to be here. Pleasure to have you.

Well, thank you for having me here. It's a fantastic view. Looks like it's not a cloudy day, which is a good sign for the theme of today's podcast, which is increasing transparency in private markets. So, we'll get to that. First, I want to get into your background. I think your background is fascinating, be instructive in terms of why we are where we are today in private markets as it relates to the market infrastructure. Your background has been at the epicenter of market structure evolution. So, would love to start there.

Luke

Thanks, Michael. It's great to get to sit down with you. We've been trying to do this for a while, so I'm excited to be here. Yeah, look, I've been very fortunate in my career. I think I'd like to say by design, but probably mostly by luck. But I've gotten to see a couple of pretty fundamental transformations, both from a technology and from a finance perspective. So, I actually started my career in robotics and automation back before robotics was cool. They were less humanoid back then. But I did a bunch of work early in my career around automation and how do you take a manual process and turn it into an automated process. And I think the things that I learned in that early phase of my career really instructed a lot of what we're still doing, even today, in my role in MSCI, which is, if you want to automate and you want to drive scale, you have to drive standardization.

You have to drive normalization. And then the processes can become incredibly efficient and repeatable. And you see that in robotics. Increasingly, we see that in the adoption of AI and the ways in which these pretty simple, basic processes can be harnessed together to create massive efficiencies and massive scale. And so, I sort of had that from a technical background. And then I started working on Wall Street in the early 2000s in fixed income, which was just a super interesting time. And the rate of change that we saw over that six, seven, eight-year period, a little bit of a financial crisis in there as well, which made things interesting. But just focusing on the mechanics of the fixed income market, in the space of a few years, we went from a world where the bond market was still a sort of white tube business. You had a trading floor full of people buying 2s and selling 30s and that was the job. And then you fast forward, you know, eight, nine years and you have central and order book trading. You have, you know, virtue in these other folks in there making, you know, millisecond liquidity in the bond markets. And it was just, you know, remarkable transformation. And I think that, you know, that movie was really interesting to me. And I think then we've seen it in subsequently instead of in other asset classes as well, but it informs a lot of how I think about what's going on in private markets. Because I saw the way in which, you know, by standardizing data and availability of data and then starting to drive, you know, price formation and then liquidity that flowed from that. The way that the market structure can just sort of completely be transformed through that. So really, really interesting experience. And then, you know, worked in a few other asset classes. Well, did a bunch of work in FX that also went through a similar transformation, you know, became incredibly efficient market. And then, and then started working in private assets. I think I was attracted to private assets for a couple of reasons. I thought that the. You know, there's this, there's this fascinating value chain in private assets that starts with, you know, with the portfolio company with the operating company and all of the things that that operating company needs to do and all of the data and information and opportunity that exists there. And then the way that that moves through the investment process through capital formation and increasingly through sort of emerging liquidity. There's just a huge, rich vein of data there, which hasn't really, I mean, I think it's coming into existence, like in real time, but it hasn't really existed before. These have been very disjoint data sets and there's a huge amount of value in, in kind of joining and kind of creating that, that connective tissue across that life cycle. And so, you know, the work we're doing in private markets is super interesting.

Michael

So, I want to touch on your experiences and fixed income effects. I think if you look at other market structure evolutions from pre to post trade, you can look at private markets and say, okay, it's undergoing a market structure evolution. What can be learned from some of those other asset classes and their evolutions? What would you say are the biggest learnings from your times working with other asset classes in their market structure evolutions? And where would you say we are in that market structure evolution in private markets?

Luke

Couple comments. I mean, I think the main, if I were to boil down the learning, I would say it's the centrality of data and the sort of harmonization and normalization of data. You know, data kind of wants to be free, but it, when it's disjoint, when it's not normalized, when it's not comparable, you know, when it's not on the same time scale or quote convention or you name it, you can't really get the efficiency. And so, it's when you start to get that harmonized data layer and then you can start to build transparency, you can start to build price formation and then liquidity and then it becomes a sort of reinforcing sort of market efficiency. And so I think that relates very much to private markets where you can't get away from the data problem. Like the data problem is fundamental and integral to the problem. And until you make progress on that, you're going to be stymied in terms of creating real scale.

Michael

I want to talk about something from a philosophical perspective because opacity of data has been, in some cases, a benefit for certain players in private markets. That relates to inefficiencies in the market. It helps certain investors buy at certain prices, sell at other prices. It maybe has created a more challenging secondary market, which we can get to as well, but also maybe some benefits for certain players. How transparent should private markets become and where are the both positives and negatives of that happening in this specific asset class?

Luke

There's no right answer. There's no sort of moral arbiter that says we must have transparency or we shouldn't or whatever. It's a dynamic market and it's a dynamic equilibrium of where that information should sit. So, I think that market participants will do over time what's in their interest. And so, there's no doubt that information asymmetry can be highly desirable. I read Andrew Roth's talk in 1929 over the break as a terrific book. But it was all inside of trading back then. There was the guys in the house of Morgan and whatever were just doing deals, and they were giving a slice at a discount to their friends. And that was just how the market worked. It's a very different world from how we exist today. But obviously that information asymmetry was valuable, but it also led to unsustainable market dynamics. And so, if you want to expand the market, you want to bring more participants into the market, you want to have more people come at capital and have predictable market structure. The sort of inevitable trade off of that has got to be information asymmetry. So, it doesn't mean that you go overnight from a world where the information was relatively controlled to a world where it's completely transparent and available. That's not necessarily in anyone's interest. But there is a tension there between scaling the market and normalizing the information for the participants. What do you think that has the potential to do to returns in private markets? There is information value, right? And I think that that manifests in alpha. And so, I think that the expansion of

information, the increased efficiency in market is generally going to tighten up returns in these markets. And I think that seems like a logical conclusion. It doesn't mean that the alpha is not sustainable. But I think as a general point, if you say in a market with more liquidity, more transparency is pricing going to be tighter. I think that's a reasonable expectation.

Michael

Well, that's a great point because it's a good segue to the other angle of this, which is as more investors come into private markets and different kinds of products get created, evergreen funds, these public-private products, enabling more investors to access private markets. You have a need for the ability to better understand and benchmark the difference or compare and contrast between public markets and private markets. So, the positive, it seems, would be you now have the ability to look at private markets in a more comparable fashion to public markets and then compare and contrast. And to your point, you still may be able to generate alpha. You'll just be able to have more transparency around how you compare and contrast.

Luke

If you want to talk a little bit more about the dimensions of alpha and where those exist and why I think those are durable. But even when there's genuine alpha, you can have an overlay, which is just a function of information asymmetry. I'm going to sell you this glass and you have no idea what a glass is worth or the fact that they went on sale yesterday, you're probably going to overpay. That's not real alpha. That's just information asymmetry. Now, it may be the glass is actually valuable and it's more valuable than the plastic cup or whatever, and therefore you're going to pay that premium. There are premiums in the investment products that I think are durable, but the market will become more efficient. And so that squeezes out that sort of information asymmetry spread, I think.

Michael

I'd love to unpack when you talk about alpha, let's get into some of the dimensions of alpha.

Luke

Yeah, sure. So, well, let's talk private equity. We've taken private equity apart and put it back together like 100 times. We continue to look at the PMEs, on the public market equivalents. We do a ton of modeling of private versus public performance and the correlations. It underpins a lot of what we do on the indexation in our costing side as well. But every time we take it apart and put it back together, we see that there is this durable alpha and it's several hundred basis points and it's

persistent across regime. So, we think that that's real. So, what are the dimensions of that? I think there's some quite interesting sort of value bridge work that's been done to decompose that and attribute it. But at the end of the day, there is managerial alpha. These firms are coming in. They are making the operating companies more efficient. They are aligning incentives; they're putting structures in place that are effective. They are strong financial engineers and they're doing sensible things for the most part in terms of cost of capital and use of debt and things like that. There is a dimension of the illiquidity premium, which is very important. We'll talk about that a bit more. But the reality is patient capital or capital, which is married to the time scale of the operating company and its evolution has value. And so, those are some of the dimensions that I think in private markets are really important. And as we think about the convergence of public and private and as those come together, how do you preserve dimensions of that and not sort of throw the baby out with the bathwater if you are?

Michael

I want to ask a question related to that. If we drill down on what the drivers of both alpha and benchmarking are, when you think about what feeds into being able to analyze benchmark performance in private markets and you can do the same in public markets, what in your mind is the atomic unit of value that you need to start with that's super valuable or the single source of truth that kind of feeds up into that? Is that the, as you said earlier, the underlying company level data and that feeds into everything?

Luke

The sort of paradox, if you will here, is the following, which is in public markets, the evolution of public market has been around the venue. That's the point of a public market is it's a boss, it's an exchange, it's a place where you come together to sort of transact on a multilateral basis. So, normalization and standardization of the contracts is sort of built into that market structure. We've had the ticket tape, this is my Andrew Ross Sorkin reading again, but the ticket tape was invented in like 1867. So, we've had prices on stocks coming across for 150 years or whatever, it's very mature in those markets. Private markets came the other way, they came bottoms up, they came bilaterally by construction. And so, as we say, how do we make these two things look the same, we're coming at them from a very, very different perspective. And so, we need to start building up the building blocks, as you say, or the language of these, essentially bilateral interactions so that we can make them fungible and comparable. That's really the challenge that we have. It doesn't mean that we need to stop doing the thing that created value, which is going out and finding great companies, investing and then backing management, doing all the things that the private markets have been good at. But we do need to start saying, you know, how are these things the same? And as we get into total portfolio, how can they be comparable to what's happening in the sort of top-down public

system? If that makes sense, that's really the crux in my view of what we're doing in private markets.

Michael

So, when you say that, my mind goes, is a quote like Marc Rowan from Apollo, you know, public is both safe and risky, private is both safe and risky. I'd love for you to unpack that conceptual framework in the context of what you just said, which is thinking about it in the total portfolio. As you think about standardization of both public markets, which is obviously further in his journey than the standardization of private markets. But how can allocators reconcile those things in both public and private markets as it relates to the standardization, how they might look at their total portfolio?

Luke

The way that we think about the private public relationship is sort of as a T-shape, right, where the vertical stripe of that is the private markets and it's the evolution of timeliness, transparency, quality of the data on a standalone basis. The horizontal, the bar of the T, is the total portfolio. So, if we want to do total portfolio, which is to say we want to put private investments or semi-liquid or that sort of continuum, *pari passu* with traditional stocks and bonds, in order for us to be able to do that in any meaningful way, the quality of the private data has to have been uplifted, right? Because if the private data is not adequately timely, if the price and conventions grow some net of fees and leverage and all these things are not adequately consistent, then when you start to try to do the total portfolio work, it's just garbage, right? And then, which is the most dangerous thing, right? Because if you actually think these things are comparable, what they're completely different, you're going to get into real trouble. So, I think that the work that needs to get done in private markets is super important and that is, you know, it's timeliness of information, it's normalization of data, it's development of a reference universe for benchmarking and performance analytics, *et cetera*. But in my mind and in our mind at MSCI, there's no getting away from the fact that, you know, allocators, asset owners are taking a financial market exposure with an intent of getting a return, right? And they're doing that in public markets and they're doing that in private markets. And so, when you acknowledge that as the reality, you start to say, how can I justify keeping these things completely disjoint? Because they're unified by the fact that I commit capital and they're unified by the fact that I expect a return on some timeline. And both of those things need to be sort of in harmony, right? And so, once you acknowledge that, then you start to say, well, how much can I make them the same and how much do they need to be different? And then you get into the whole total portfolio journey that we're on and we're doing a bunch of work around tools and techniques for that.

Michael

What do you think about that? How much do you think should be the same and how much do you think should be different and what should be the case in both camps?

Luke

You brought up a philosophical question, so I'm going to tell you my favorite philosophical example now. You can see what you think of it. So, there was a paradox called the Ship of Theseus. So, Theseus would, like, win around and, like, slew the Minotaur and did all kinds of great adventures, and then he found that Athens. And so, they docked Theseus' ship in the dockyard at Athens and they kept it there for hundreds of years because he was a great hero and they wanted to commemorate him. And, you know, the ship was all it was wooden, it was kind of rotting, and so they would go and replace, you know, a plank of the ship. And over time, they replaced the planks, and at some point, they'd replaced all of the planks with new planks. And so, the paradox is, is it still the ship of Theseus or is it a new ship, right? What's the identity? The reason that I bring that up is, I think it gets to the crux of should private markets be public markets, right? At the point where you make them the same in all respects, right? The expectations of liquidity, the expectations of transparency, the expectations of, you know, capital availability. Are they the public markets? And is there anything, you know, different or unique about that anymore? And I think that's a question that I think gets glossed over. People are all gloved. They're like, yeah, you know, private to the new public and that should all be the same thing. I don't think that that is a good organizing principle. Like, I think there's reasons why things are, you know, what they were historically, and we need to make sure that we unpack and continue the things that add value. Otherwise, we will just have an extension of the public, of the public market.

Michael

So, let's stay philosophical here for a second. As you talk with both asset owners and asset managers, as you're building out the indexation, the benchmarking, et cetera, I want to talk about this from a behavioral dimension. So, continuing on your point, which is if we make private markets so much like public markets, then it's just an extension. What would that do from a behavioral perspective to investors in private markets? Do you think if the more public, more private markets becomes like public markets, does it change their behaviors and the way they invest?

Luke

Well, I guess my thesis would be if you really collapse them, then they become, you know, sort of interchangeable. And so, what's the delineation of being a private market investor? You know, I think we go to private markets for returns. We go to them for diversification. We go to them for, you know, duration matching in some cases where we can get the return on that duration. And I think

those are already valuable building blocks in an investor's toolbox. And so, again, there's no moral arbiter like the market will do, you know, what the market thinks makes sense. But I do think there will be an equilibrium point where there are, you know, late-stage venture is a good example, right? And we have, you know, we have some indexation around that and people are building products. So, you know, around that late-stage venture segment, you know, that looks a lot like public markets in certain dimensions, right? These are very large firms, large market caps scalable. Even though the transparency isn't there that you get with a public company, there's still a lot of information available. And so, you know, that's much closer on the continuum to public markets. And, you know, that sort of feels appropriate, right? But if you want to go and do a, you know, a distressed loan, or you want to go and do venture capital, early-stage venture capital, or you want to do growth equity, you know, these are not the same kinds of products, right? And trying to make them look like public markets is kind of a fool's errand. Like they just don't have those characteristics. And then the capital would be very expensive if they needed to jump through all of those hoops. So, in my view, you need to be able to tolerate a broad diversion.

Michael

So then where are we in the building blocks? If we talk about the infrastructure as well as what you're building at MSCI, what are the building blocks in your mind that have been built and formed at this point, as it relates to private markets, continued evolution in market structure?

Luke

So, in today's market structure, it all starts with manager reporting, right? That is the source of truth. You know, will that evolve over time? Probably, especially for some of the, you know, the larger assets where there'll be more of an ecosystem and there'll be more third-party information that becomes available. I mean, you already have an AI will be interesting in that dimension as well, because you start to have the ability to model these entities, you know, from the outside, even when they're relatively private, because there's more data available, and you can draw more correlations. But today, the managers are sort of the source of truth with their reporting and their marks. I think that we've made a lot of progress in these domains. I think the manager marks have been tested through different domains. Obviously, COVID was a big shock. You know, a lot of denominator effect issues there, a lot of upwards sticky marks, you know, sort of being interrogated by all piece of, you know, why these are marks. And so, I think that that, and then, obviously, as you get into evergreens and potentially more regular marking, right, and more transparency around that, it's driving, you know, I think better discipline, some tooling. There's some interesting vendors in the space that are doing things there. So, I think that whole process of marking is going to get, you know, smoother and easier. And then the amount of disclosures on the operating companies or the loans themselves has just gone up significantly over the last several years. I think LPs have gotten a lot more demanding around, you know, we want to understand, you know, what's in this fund and

the characteristics, et cetera. There's been a lot of pressure from the LPs and the GPs have sort of come to the party on that. So, that baseline level of data, I think, has gotten significantly better over the last, you know, call it 10 years.

Michael

One place for my mind goes when you mention denominator effect. A lot of institutions were impacted by that post-COVID. And that had a ripple effect on private markets, on their institutions' allocations. I think, in part, has driven continued interest in the wealth channel. That wasn't going to change if institutions didn't have the denominator effect. I think it probably accelerated it. But it brings up an interesting point as it relates to the LP side of the equation. One, they now have to think about more active portfolio management. I think that gets into a pretty interesting discussion around the secondary market and how secondaries are evolving to be becoming a solution. And then it relates to what you've done with Burgess. You bought one of the best, if not the best source of data on private funds in Burgess and you own Burgess at MSCI. How do you think about this concept of active portfolio management from the LP perspective and how are data solutions, like what you're building at MSCI, helping LPs, put the piece of the puzzle together?

Luke

Yeah, that's a great question. I think one point I'd make that I think is important is, again, if we buy this theory that total portfolio is an increasingly important view, which I think we do, then you say, well, what are the dimensions of active portfolio management in that total portfolio? And an important one, we'll talk about in a second, is obviously actively managing the private aspect of that. And so, the second reason is the key dimension to do that. But the other aspect of it, which is really important, is the public part of that portfolio is sort of liquid by construction. And so if you have a total portfolio where one side of the portfolio is less liquid, more sticky, more constraining, there's a lot that you can do on the other side. And so, this is where total portfolio becomes quite powerful because you start to think about balancing liquidity and exposures across the total portfolio, and you may have a lot more liquid options in terms of that rebalancing before you need to go to the liquid side, which is the primary.

Michael

Where my mind goes with a lot of what you just said is, there's this need to understand both public and private. You recently launched an index that covers both public and private, which I think could be pretty instructive as you think about some of the evolution of product structure, product innovation in private markets, whether it's with evergreens, and then investors have to think about both their private market exposure and public market exposure, or even these public-private hybrid

products. How is that unfolding and what does that mean in terms of how investors are now thinking about their public and private exposure?

Luke

Yeah, so that was a pretty cool product. It's an 85-15 blend, which is somewhat arbitrary, but it seems like a good mix. Between equity, IMI is sort of the investable world, public-equity universe, and private equity, the 15% sleeve. We thought that was a really interesting product for a couple of reasons. The first reason was in order to do that, you need to daily price the private-equity side of it. If you want to have a daily index that combines those two things, you can't have a stale price on the private side. That brought together a lot of research and work we've been doing over the last several years around what does it look like to put a daily price on private equity, and how would you do that? Given that the source of truth is the manager marks, those are quarterly, and they're generally lagged, how do you do that? I wouldn't get into the details. There's some white papers and things on the blog. Basically, we're able to produce that daily price so that we can now produce a composite price. It's interesting for a couple of reasons. I think that it speaks to the fact that many investors, especially institutional investors, have a broad exposure to equity. In some cases, they have 30% exposure to private equity. It's very substantial. They are exposed to global equity across public and private, and so why not give them a lens to look at that through? It also starts to maybe open up methodologically some of the challenges that lead to the denominator effects that you were talking about. There hasn't been great standardization in how people think about marking the privates to market. Some people use PMEs. There are a variety of benchmarks that sort of float around, but they're not sort of normalized. One of the things that you see with that denominator effect, which is kind of perverse, is public's gap down, private stay upward sticky. Now you have a denominator effect. Is it real? Is that upward sticky in just a factor of smoothing? Or is it economic? Then the perverse side of that is, well, now we're unbalanced. Now we need to go to an LP secondary sale at a discount. But if we actually priced at the discount we got in market, we probably wouldn't have had the denominator effect in the first place. It's a little perverse. We think giving asset owners a tool to think about world equity in a holistic way. Obviously, there are many slices and variations that you can create off that index. It is a very useful tool to start thinking about total equity exposure.

Michael

What data or technology solutions are available now in private markets to enable you to price private equity daily? And what's still missing from the market structure?

Luke

Yeah, so when you think about pricing private equity daily, you're doing a few different things. You're obviously using the manager marks, and you need a very large data set of both current and historical marks, and that's something that we have. You mentioned the Burgess data set required, which is very valuable in that regard. So, you need that deep data set, and you need to keep updating it. So, you need to have a broad range of marks that are coming in on an ongoing basis. But then to get to the now casting, you have to do public market correlation. You essentially have to build that model that says he has a representative cohort of public market equivalents, durable correlations, and therefore we can kind of impute whether private certain there's econometrics by my pay grade of how those things get blended together. But you're essentially using a combination of the most current information that you have from managers and these sort of imputed relationships to the public markets. And that's a pretty well-developed sort of science around that. The dimension which is interesting is how secondary prices start to feed into that. And I think the evolution of the secondary market is going to be extremely symbiotic with these data tools that we're building. Because the data, better indexation and information where imputed price is, accelerates price formation and accelerates the bid process. It accelerates the time to close on secondary transactions. And then the information that's coming out of those transactions is positively feeding back into the development of those indexes, those prices, et cetera. So, I think that's going to be a flywheel effect that we're going to see I think the last number I saw, I think, you know, secondaries was 220 billion or so last year and roughly between GP and LP, that's a 40% growth rate. So, it's a big business. It's growing really fast. I think it's going to be highly impactful. And I think those secondary prices flowing back in time into the overall pricing model is going to be very significant.

Michael

But it's only a single digit percentage points of the total private equity market size, right? So how should we think about secondary markets in the context of derivatives markets? What can secondary markets and those in it learn from what happened in derivatives?

Luke

You know, I think the parallel that maybe I would draw is actually the fixed income. So, if you look at, for example, a fixed income mutual fund, right, those are liquid. You know, you can trade them every day. Only a couple of percent of the bonds in most mutual funds actually trade on any given day. So, it's largely a liquid, but we trust the NAV, right? And, you know, a lot of the pricing in that is just matrix pricing. Like the price of the bond is matrix priced. It's not actually an observable trade, but there's enough marginal liquidity that people feel confident that that's the right NAV and that's where value is. And so, I think by analogy, we don't need a large proportion. A large proportion of these private markets to trade for us to get a lot of price discovery and a lot of anchoring on value that can then open up the potential for a derivative of market. Because in order to write a swap or a

note on the other side of his basket, you know, I just need to believe that the price formation is robust, right? And that's where I think indexation, you know, some of the stuff we're working on, for example, and others has a real role to play because you start to bring an independent measure of value that's methodologically robust and now, I can start to take the other side of that trade. If the value is entirely, you know, generated by the principles, kind of idiosyncratic, it's much harder for me to take the other side of that bet because there's all kinds of gaming issues and just transparency issues. And so indexation and price discovery can enable, you know, it can enable more liquid products, and it can ultimately enable the derivative of its market.

Michael

What do you think it will take to create more trust and transparency around indexation or benchmarking in private markets?

Luke

Certainly, well, data obviously is the key input, right? So, as the amount of available data goes up, you know, by multiples or orders of magnitude, the formation of those benchmarks is just much more robust. It's just like a law of large numbers, right? That stuff becomes robust. And then I think the other side is use and adoption, right? As people use these things, as they see them tested through different market cycles, different kinds of dislocations and see that they actually do provide a useful signal, whether that's on performance or allocation or risk management, people will adopt them more and use them more broadly.

Michael

How does this all relate to the increasing unlocking of access to the wealth channel? And I'm going to the kind of end point of that, one of the end points, 401ks, how much can all the work that you're doing at MSCI help get those in private markets and those around private markets more comfortable with, to your point, as there's more data, more transparency. It becomes easier to enable more investors to access private markets.

Luke

No, it's a great question. And it goes back to your earlier question around, do folks want to give up information capacity, give up information they sum at tree, right? This I think is where the rubber meets the road on that trade-off, right? The wealth opportunity is massive. It's growing very rapidly, but we've only scratched the surface on that opportunity sale. I think private investors, well, wealth

investors want to be in these markets. They think they're attractive. They think they're interesting. They like the return characteristics. This is not a product being pushed down, looking for need. I think there's genuine sort of design for these products. And so, it's a huge opportunity, just massive opportunity. But in order to get there like a bunch of things need to be true, they're not completely true today. And the amount of allocation, the proportion in the portfolio is sort of the key deciding factor here. If you have a de minimis allocation to private markets, a few percent, you can really live with the fact that it's just the sort of thing off to the side. It's nominally uncorrelated, nominally has alpha, kind of a liquid. That's fine. It can have a small place in the portfolio. If you try to increase the size of that, and particularly if you start to bring it into retirement and these very sorts of fiduciary structures, you can't just say, well, it's this weird thing off to the side that we don't understand, right? Why did we make this allocation, right? Why did the advisor say this was an appropriate product for this portfolio? And you can't really do suitability if you can't decompose and explain what this thing does. So you need to be able to understand liquidity characteristics. You need to be able to understand, frankly, in these semi-liquid vehicles, what some of the stress constraints are, right? If there's gated liquidity, what does that really mean in practical purposes? Can I explain to my client what that might look like? And you need to be able to do sort of factor analysis and exposure analysis on the total portfolio, because if I'm going to have a 15% allocation of these private markets, now I have specific sector, geopolitical, you name it exposures, that I need to understand across the portfolio. But I can't just ignore them in one side of the portfolio if that's going to be material. And I think there's a lot of work that we as an industry need to do in that space. I mean, that's something we're doing a lot of work in. And I think that that unlock of giving advisors, giving home offices, the tools to understand how do I do portfolio construction that's mixed public private, but that's rigorous because the rigor on the public side is very high, right? We have great tools; we have great analytical frameworks. They're very well understood. They're used consistently. No one's going to create a public portfolio on a hunch or an intuition, right? It's just it's not going to work. But the private side does not yet have that level of rigor. And so, I think we need to rapidly uplift the quality of the data and analytics so that people can start doing more holistic portfolio construction. And that's going to be a massive unlock on growth.

Michael

What are the questions that advisors are asking you as it relates to, if I'm an advisor, how should we think about benchmarking? How should we think about how this data interacts with our broader portfolio or asset allocation? How should we think about how it impacts risk, volatility, alpha versus beta? What types of questions are they asking you as you all collectively work together to kind of create more of that rich data that'll help them do their job better?

Luke

Yeah, I mean, it's a number of those things that you've enumerated. I think liquidity is very important. Especially when you're in a world of ultra-high net worth and private placement, people do understand the characteristics of these investments. As you come down market and even leaving the regulatory dimension of it aside, you really need to make sure that people understand the liquidity characteristics because getting stuck with a mismatch of expectation versus reality on liquidity would be very bad for the market and very undesirable. So, one of the key things that we hear are questions around liquidity, and do we understand the liquidity? Does the expectation match the reality across a variety of scenarios? I think that's probably the number one question. And then the second one is all the things that you've said. How do I actually do some sort of factor decomposition on this and make it more side by side with the rest of my portfolio and risk management?

Michael

So sometimes perception is different than reality. As you now get to see so much data, sometimes data tells you answers that otherwise you wouldn't be able to get. Are there any surprises from your perspective? Is there anything that you wouldn't have thought to be the case as it relates to private markets or the benefits of illiquidity or the issues of illiquid, or something related to the data that you're seeing and getting that has surprised you? That is a misconception that many have about private markets?

Luke

Yeah, I think the thing which has been gratifying, I may be surprised at the struggle, but certainly gratifying, is we have taken these private products apart and put them back together a bunch of different ways, and the alpha is durable. So, the reason that people go into private markets is borne out by the data, and as we get more data and we go deeper on the analysis, it's robust. And so it's always comes in and out of fashion, but it's always like low grade fashionable sort of just private markets and say about the fees and even net of fees, even really looking very rigorously at it, we see in private equity and private credit, these are just great investment vehicles, like there's real value in there, and so that's been gratifying to see, I think as we've gotten deeper under the hood.

Michael

What's the next layer of nuance there? Is it the, I think we all know getting in the top quartile or top decile managers generally tends to outperform, and that matters a lot, certainly in more asset classes than others, right, the interquartile spread is wider in something like venture, as an example relative to large buyout. Yep. But is there any nuance to what you just said as it relates to private markets relative to public markets, that you have to be in managers that are first or second quartile

in a certain asset class in order to have that durable alpha, or is it private markets quite large? Like could you, I'm getting what I'm getting to is kind of, could you create an index for private equity and if you allocated to the index, you'd beat public markets?

Luke

I'll give you the answer, I'll need Kristin to sort of prove this for us, but on the question of can one create an index that would replicate but outperform public markets? We launched an index several months ago called PERT, private equity return tracker, and what we did there was we took the rich historical data set that we have on private equity, and we said, you know, what would it look like to replicate that with a basket of public equities, right? And so, we built a very built and back test that a very rich model, and we now have an index that we produce that is a representative basket that replicates as best we can the performance of private equity, and Goldman actually launched an ETF on top of that GTPs. I think it's a ticker. And so that's a, you know, that's a passive ETF product that replicates exposure to private equity, and in our analysis, you know, there's a couple of hundred basis points of alpha in that product, right? And a lot of that is driven by sector tilt, growth tilt, there are a number of factor tilts that constitute that portfolio, but that seems like a, you know, like an outperforming portfolio. It doesn't perform as well as the closed-end fund direct strategies. So, you still, you know, you still leave, you know, 150, 200 basis points on the table, as opposed to the direct strategy, but it's a really interesting, intermediate sort of product. And I think what that's telling us is, you know, there's real skill in the manager selection and in the sort of portfolio construction that's going on in these alternative managers.

Michael

I want to relate what you just shared to something you said earlier, which was really understanding the nuances of the, like, public versus private and what these, what certain features of each asset class mean. I think we probably both agree that words matter, definitions matter. If you had to tell those in private markets what nomenclature matters and or needs to change or evolve. So, I'm, I won't, I won't lead you too much, but things like liquidity or other, other words that are these weighty words that are trying to help people understand what's actually happening in private markets, both from a philosophical perspective, but also from a data perspective and an analytical perspective. What are some of those words that you would choose and why?

Luke

I think liquidity is a real word. It's maybe used a little, a little glibly, like I think you need to define what liquidity really means because as we've seen, you know, throughout various market stressors,

you know, liquidity is, is not always there when people expect it to be there. And so understanding your definition of liquidity, I think is really important.

Michael

Do you think different investors can have different definitions of liquidity? And that's okay. Or do you think related to your point earlier about the market moving toward standardization? Are there certain terms or worldviews that need to become standardized in order for the market structure to continue to evolve?

Luke

People should use the same words to mean the same things. Otherwise, they will get confused and that that won't be good. It doesn't mean that everyone's, you know, requirements of liquidity or definition of what good liquidity means needs to be the same. So there's, there's value in long duration products. But there are investors that have very long-time horizons on their capital. And it's desirable for them to have vehicles to put that capital into where they can get the benefit of that liquidity. Right. And so not everything needs to be ultra liquid. And so, a retail definition of liquid and a, you know, a sovereign, wealth fund definition of liquid or expectation of liquid should not converge. That would be a bad thing and that would be value destructive. They should use the same words to mean the same things. And so, you know, if you think back to, you know, your accounting, your quick ratio and things like that, but let's, let's have standardized definitions of what we mean by that kind of liquidity. And I think that that's really useful and especially in the wealth channel. There's more that we can do that create that new, as you say, new kind of lexicon or set of terms of what do we mean by these things would be, would be really useful.

Michael

How do you think you can play that role as the connective tissue that helps both GPs and LPs and then within LPs to your point of sovereign may be very different from an individual in terms of what they need their liquidity horizon, their duration. How do you think you can be that connected tissue to help those constituents piece it all together?

Luke

The thing that I like about MSCI and that makes this job so interesting is we are, we're, we're independent in the market, right? We're not, we're not pushing product. We're not raising money. We're not an investment advisor. We're not doing any of those kinds of things. We really are trying

to bring, you know, clarity to these markets to allow them to function better and to allow them to grow, right? And so, in order to do that, we need to work with the people that are actually creating the risk, which is the managers. We need to give them information that we have, right? Just from the universal things that we see so that they can be better at creating risk, right? They can be better at understanding, you know, from the, from the universe of data, what investments are good? What are bad? Where's the world going? What's happening with tariffs and de-globalization and supply chain? And there's a wealth of data there that can enable managers to, to generate better risk. There's a wealth of market information around capital flows and LP behaviors that can help them understand where the puck is going. And help them think about product design and product creation and bringing the right products to, to market at the right time, which is, which is super important. And then we can collect, you know, ever increasing the granular and high-quality data from those managers. And I think in the process of collecting that data, help them think a little bit about standardization and normalization of the data that they generate so that not everything is kind of ex post normalization, but it can be a little bit ex ante sort of standardization. I think that's already happening, but we could do more there. And then we can help the, the asset owners and allocators obviously understand that investable universe, right? They can understand from a fund selection and investment perspective, you know, how do I feel about this versus that? They can understand, you know, crew manager performance and also crew strategy performance over time. And we can give them tools to understand the total portfolio and how to think about continually rebalancing or sort of dynamically managing that portfolio. And I think things like indexation, benchmarks, you know, risk analytics, these are all super useful items in the toolbox to create, you know, a more harmonized view across, you know, across public and private markets.

Michael

I think that's such a great way to wrap this up. The harmonization between public and private, I think encapsulates a, your career journey, the journey that private markets is undergoing with that market structure evolution. You talk about kind of being a connective tissue. And I think how do you get to that source of truth that is independent? I think all of that is encapsulated in what you just shared. This is a fascinating conversation. Thanks so much.

Luke

Terrific. Thanks so much for having me. I really enjoyed that discussion.

Michael

Thanks, Michael. Thanks so much. Thanks for listening to this episode of Alt Goes Mainstream. I hope you enjoyed it. You can read more about alts at my Substack, altgoesmainstream.substack.com. Thanks a lot, and have a great day.

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