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TRANSCRIPT

Can Private Assets Withstand So Much Public Attention?

Featuring: ***Peter Shepard****, Head of Fixed Income, Multi-Asset Class and Private Asset Research and* ***Brian Schmid****, Global Head of Product Management and Applied Research at Burgiss.*

Adam Bass (00:03):

This MSCI Perspectives, your source for insights, for global investors and access to research and expertise from across the investment industry. I'm your host Adam Bass. And today is March 18th, 2021. Today I'll look inside the world of the aptly named private assets. Though investing in this way isn't new, many don't know too much about it, in large part because only the most sophisticated investors with large amounts of capital have been allowed to take part. Today those investors are looking at private assets differently, expanding and shifting the role the investments play within a multi-asset class portfolio. To help us sort through all this and more, we asked two people who spend their days inside those private walls to give us a tour, starting with Brian Schmid, head of product management and applied research at Burgiss, which provides data solutions to private asset investors and funds like.

Brian Schmid (01:01):

Within the world of private asset classes, there's certainly a number of sub-asset classes that makes it real for folks. Probably most folks are aware of private equity. Private equity is inclusive of both buyout and venture capital. A buyout is where largely it's about taking a public company private to therefore make improvements and then relaunch or relist that company to, as a public company. Venture capital is about taking equity investment in early stages of startups and the like, and bringing those to IPO or to a strategic buyer. Private debt is another private asset class, similar to private equity, but the stakes that are being taken in the portfolio companies are through credit or through loans that are being provided to private companies. And then there's private real assets such as real estate, infrastructure or natural resources. And through private real assets, both equity and debt stakes can be taken in those either properties or projects or the like.

Adam Bass (01:58):

We'll talk more about private equity, private debt, and private real assets later on. For now let's look at the ways in which investors can access them all.

Brian Schmid (02:07):

Now, institutional investors can invest in private asset classes through various types of investment vehicles, including through fund to funds, through funds, through co-investments, and can take a stake directly in the underlying private company through a direct.

Adam Bass (02:22):

Brian went on to explain that a co-investment is called that because it exists along with, rather as part of the money an investor has in a particular fund. The fund manager, who's also known as general partner or GP still may be the one to arrange this deal, and the potential investment can be a fund holding. The difference is, the investor puts money directly into that company, but getting back to how the funds work.

Brian Schmid (02:50):

So take, for example, an investment in a private equity fund that may focus on let's say, buyouts or ventures. So in the funds life cycle, there's three phases, there's the investment phase, the investment stage where the GP is finding opportunities or finding companies to invest in, there's the growth stage that post-investment from the GP into the underlying portfolio company, it's about that GP working with an underlying portfolio company to grow the company, so to make improvements and grow the company. And then eventually the third phase of the fund's life cycle is the harvesting stage where that GP is looking for opportunities to realize the gains through, let's say an IPO or through strategic sale.

Brian Schmid (03:27):

Given that life cycle, the cash flows between the GP and the investor, so GP being the fund manager, those cash flows are not at the discretion of the investor. So the investor committed capital up front. And at the end of the day, the GP has the discretion of when to call capital calls, so when that money is going from the LP, the investor to the GP, or when distributions are being made from the GP back to the investor. So again, the cash flows are at the discretion of the fund manager, because they're calling capital when they see the opportunity to invest.

Adam Bass (04:04):

Now that control of the cash flows by the general partner, these capital calls where any portion of committed money can be well called for or demanded. That's an important

distinction between private and public capital markets. It also brings us to the key aspect of liquidity or more to the point, private assets illiquidity. And for that, we turn to...

Peter Shepard (04:29):

I'm Peter Shepherd, I'm head of fixed income multi-asset class and private asset research at MSCI. Been here for about 14 years, leading a big research team, doing lots of different things. But private assets has been a big focus of ours over the years, developing models for private equity, private real estate, private infrastructure. I think around liquidity specifically, one of the biggest things that asset owners grapple with is, when you sign up for private equity, it's not like a typical mutual fund or something where you give them your money and they deploy it, you sign up for private equity and you're making a commitment of capital. And then they go hunt around looking for deals. And when they found a deal where they want to deploy that capital, they call it. That structure gives the general partner the leeway they need to do what they do. But the liquidity burden that it puts on the asset owner, can be pretty tricky.

Peter Shepard (05:32):

The asset owner can be in a position where all of a sudden they are asked to come up with a lot of capital quickly, especially in the market downturn, this can happen. There's a market downturn, the general partner sees market opportunities, stuff looks cheap in a crisis to the general partner, they call a whole lot of capital in the middle of a crisis, when liquidity is sort of at a premium. And the asset owner has to come up with that liquidity over a very short horizon. That kind of risk is front and center for a lot of private capital investors. And that liquidity risk is probably more important than the other, what we would normally think of as little liquidity risks that, like once you're in it, you're in it.

Brian Schmid (06:23):

So managing your liquidity through that is an important part of investing in private assets, understanding, being able to estimate when capital calls are going to be received, being able to estimate when distributions are going to be provided, and be able to just manage your liquidity through that horizon. In addition to that, or maybe alongside of that, again, publics versus privates, I mentioned earlier, when you allocate to publics on day one, that allocation is made in privates on day one, you're making your commitment. You're committing a hundred million dollars of which $10 million of that might be called in the third month or the six month.

Brian Schmid (07:04):

So when you committed a hundred million dollars, that money is not in the ground earning the premiums that you would expect it to be earning in the private asset class. Because of that, you have to plan appropriately, a method that's called pacing. You need to pace your commitments over time, such that you would achieve the allocations that you desire within your portfolio. There's tools that Burgiss provides, and other provides to allow you to, let's say appropriately pace your commitments, such that you can achieve the asset allocation that you desire in, let's say your strategic asset allocation planning across your portfolio.

Adam Bass (07:40):

Illiquidity is not just a risk, however, especially if you're a long-term investor. As I mentioned at the top of the episode, investments in private assets are growing. I asked Peter why he thinks that's happening.

Peter Shepard (07:52):

There's a few different things, actually. I think the biggest is probably they've seen returns and they want a part of it. So the performance of a lot of different segments of private capital has been pretty extraordinary for decades by and large. And people want a piece of it. I think there's been among asset owners, the Yale Model, which is kind of an old story at this point, drove a lot of asset owners to be much more aggressive in going into private capital, for long horizon investors who don't necessarily need liquidity. But I think there's actually more to it than just that story. Another big theme that we're seeing today is, a lot of asset owners re-evaluating their income portfolio. The income portfolio has been a big part of a lot of large institutional portfolios, both for income, but also for kind of the potential risk hedging properties, that fixed income has played on in a lot of portfolios.

Peter Shepard (08:55):

When equity goes down, bonds have tended to go up, and the two have balanced out. In today's yield environment though, a lot of investors are questioning both pieces of that. They're questioning, there's not nearly as much income to be had in fixed income anymore. And then they're also questioning, how far down can yields go to provide that sort of flight to quality cushion. I think a lot of institutional investors are looking at a lot of real assets, potentially replacing a significant part of fixed income in the old portfolio. That said, maybe they need to recognize that yes, the income is similar, but the characteristics can be very different. There can be a lot more growth sensitivity and different inflation characteristics, different real rates sensitivity in these real assets, different from fixed income. And so it plays that role, but it also plays different roles in the portfolio

Adam Bass (09:54):

And asset owners shifts in approaches to portions of their private asset holdings. Well, that goes beyond swapping real assets for private debt.

Peter Shepard (10:02):

Traditionally, investors looked at private assets as, there's equity, there's fixed income, there's private. Let's make an allocation decision to each of those buckets. But I think a lot of investors are realizing, wait a minute, okay, operationally, yeah, a lot of the private assets have similar operational considerations. But as far as what's driving the returns, private equity in some ways can look a lot more like public equity, than private real estate. So rather than saying, let's allocate to private assets and then figure out where we want it, increasingly they're shifting into a more factor based asset allocation framework where they say, how much overall growth sensitivity do we want? Or maybe how much generalized equity exposure do we want? And then let's figure out how much of that is coming from public equity versus private equity, et cetera.

Brian Schmid (10:55):

Yes. And this continues to evolve. I think this varies by institution. I'd say, 10 years ago you wouldn't have seen that, 10 years ago, you would have seen the privates being a completely separate team than the publics. These days, it's more integrated across the portfolio. Then listen, which tools, there's certainly still someone at the end of the day, selecting which funds to invest in within the privates portfolio. So there's portfolio managers that are focusing on the private asset classes, but at the end of the day, there's a CIO who's looking across the total plan and whether or not he or she is deciding whether or not to distinguish between private and public, I think varies across the spectrum.

Adam Bass (11:36):

This total portfolio approach also exposes a truth, Peter feels many may not have recognized.

Peter Shepard (11:42):

Private asset valuations tend to be quite smooth. They are sort of subjective and they get updated kind of, as typically as a GP changes their books. A lot of investors had thought that because evaluations look smooth and uncorrelated that they're low risk. And increasingly investors have recognized, wait a minute, no, that's the valuations are smooth, the valuations

are uncorrelated, but the underlying value is exposed to the same economy as everything else. So if the economy tanks, it doesn't matter if it's private equity or public equity, public real estate or private real estate, the assets are exposed to the same economy and exposed to a lot of the same systematic factors driving everything.

Peter Shepard (12:29):

And not all of them, the public market equity risk premium can jump around and driving a lot of noise in the public markets. The liquidity premium can affect private assets very differently from public. But it's just understanding of, to what extent are private assets exposed to a lot of these same factors driving everything else? To what extent are they different? Is a key question that has really been obscured by the lack of transparency and a lack of really robust valuations.

Adam Bass (13:03):

Okay. Who had transparency on their private assets, bingo card?

Peter Shepard (13:08):

I think as allocations continue to rise, if they do, I think it's unlikely that it would continue under this current structure. I think you need more transparency into the space. Risk management today is pretty patchy. That might be okay when private assets are a tiny sliver of the overall portfolio, but as more and more capital is allocated there, a lot of the standards that have been commonplace in public assets may need it to take hold in private assets as well.

Adam Bass (13:44):

All of this reminds me of conversations we've had on this program actually pretty recently around ESG and climate, as well as diversity, inclusion, and equality efforts. Now those were, again talking about listed assets, but in terms of transparency and reporting with ESG and climate specifically, it seemed to come down to a willingness by companies to disclose. But more importantly even, it came down to standards or lack thereof. How does this compare in the private space?

Brian Schmid (14:19):

Yeah, it's similar. So in terms of willingness, there's certainly a willingness of managers to provide disclosure, to help their investors. That's undeniable in terms of their willingness to provide transparency. The questions then become, what is needed to satisfy their investors needs and how to go about accomplishing that. Listen, at the end of the day, Burgiss serves over a thousand institutional investors in private assets, and the information that we are provided is the same information that's provided to those investors directly.

Brian Schmid (14:52):

We just make sense of it and kind of put it all together in a convenient form for consumption by the end clients, inarguebly across the entire portfolio. So different asset managers have different levels of staff, different capacity to different things. So at the end of the day, listen, if investor's needs vary across the investor cycle, it's up to a GP to then satisfy those needs in the best way they can. But those GPs vary from GP to GP. The smaller ones may not have the capacity to satisfy all the needs of the end investors, but the larger ones have the staff and the people that can help do so.

Adam Bass (15:32):

Given what you said, especially around the willingness, in your view from your experience, do you see transparency increasing even more so over time?

Brian Schmid (15:45):

Undoubtedly. The demands are continuing to increase across the spectrum. So listening, the two examples I would highlight, one is the private debt, so increasing levels of allocations to private debt, increasing numbers of managers, either launching private debt funds. So if they were already in private debt, they're now launching newer and larger funds. And if they weren't in private debt before they are now increasing their capabilities to include private debt. If you looked three or four years ago, the levels of disclosure around the terms and conditions within the securities within private debt funds was limited. We've just gone through and reviewed all our manager reporting and found disclosure to have improved significantly since it did three or four years ago. And that's no doubt driven by the demands of the institutional investors in those funds. I would expect to continue to see that to improve in terms of levels of disclosure around the security details required in private debt.

Brian Schmid (16:47):

In addition, I'd say the second topic is, around ESG. So ESG, that is an area that there's a lot that can be done with the data that's already provided today, in terms of details on portfolio companies, in terms of the industries and sectors of the underlying portfolio companies. There's a lot that can be done to infer, let's say the ESG qualities or sustainability dimensions, if you will, of a client's portfolio, in aggregate, based on the information that's available today, but to do more than what's available today, to get very specific around portfolio companies, let's say carbon exposure or portfolio companies impact in different sustainability dimensions. Especially let's say, the clients understanding the underlying operations of portfolio companies, where the factories are, and the like. That's going to require additional information on those underlying portfolio companies. So if the GPs can provide more information on the underlying portfolio companies, and when it's not available, how can we infer based on the data that is available, the data points that are required for, let's say for climate, for regulations such as SFTR and a EU taxonomy, and the like.

Peter Shepard (18:04):

I heard a general partner recently say, this is problem number one for us is, how do we make sense of climate and any ESG? And clearly, limited partners, asset owners are feeling that same sense of urgency. It's funny, a year or so ago, especially in the US, it was kind of off the radar, and now it's just front and center. Climate is probably where people are seeing most urgency. And that's understanding the physical risk of a property is a big part of that. And we've explored that, climate value risks for real estate. But then there's climate risk to private equity, is a big focus. Then beyond climate, there's a lot of other ESG there, that is a focus. It's a hard problem certainly, but it's been amazing to see almost overnight how private markets have gone from zero to... Not zero to 60, because they're not there yet, but overnight the importance of climate in ESG and private capital, when some off the radar, to front and center.

Adam Bass (19:25):

There's one more step we need to make, as we travel down this transparency path. It has to do with increasing the ability of investors and private fund managers to analyze and benchmark their portfolios. I started by asking Peter about it. I'm also curious, you mentioned factors before, obviously again, we keep drawing these parallels between public and private. Factor investing has become a way to dig deep into, not only a portfolio, but individual holdings to, as you know better than I, to see what drivers of risk and return am I actually exposed to? How is that playing out across private assets?

Peter Shepard (20:09):

You mentioned the parallels between public and private, and I think that's a key question that we have in a lot of these things as, to what extent will private assets converge more toward public, both in their returns, but also I think sort of the practices of managing them, versus, how are private assets just fundamentally different. And we'll always have a different framework around them. It's not either, or, I think it's going to be some combination of both. Factors is an area that I think highlights that. So we're looking at factors to private assets on two different levels. At maybe the asset allocation level or the overall systematic behavior level, we're looking at, what exposures do private assets have to traditional factors? Those traditional systematic risks. How much of private asset returns are due to what we think of as the sort of pure private effects? So liquidity premium being a big one, but there's others.

Peter Shepard (21:17):

Venture capital moves, so venture capital is extremely idiosyncratic. Individual companies can be wildly successful or fail. But there's also this really strong overall venture capital factor that we see that is kind of the mood in Silicon Valley or the mood on Sand Hill road. SoftBank pours a bunch of money into venture capital and valuations go up and stay. And so there's that level of factor that we see, and it's very important. Another kind of factor though, that we're just exploring, and we've been starting to explore this in private real estate is, more traditional style factors. So it's style factors, traditionally your value, size, momentum.

Peter Shepard (22:10):

Well, they're not going to carry over exactly. So momentum doesn't make a whole lot of sense for a private asset potentially. But what we've been seeing in private real estate is that, a lot of what we think of as factors in the public markets, are actually getting at really important and potential universal investment themes. So value is universal, understanding the fundamentals driving an assets value relative to its market value. There's something fundamental about that. Liquidity can be fundamental. Sustainability is something that we see cutting across a lot of different asset classes, certainly. And so what we're realizing is that, you can't just sort of copy and paste from public and private, but a lot of the things that drive investors in one market are related, they show up in the private markets as well. And we're starting to see that yes, these factors or variations of these factors can make sense in these other markets.

Adam Bass (23:16):

The idea of a venture capital factor is fascinating. And it reminds me of a lot of the work that's been done recently in terms of different types of consumer sentiment factors, or even an ability to have employees work virtually factor, different ways to analyze and get at what may

be driving performance. So that's fascinating, especially with something as you say, idiosyncratic as venture capital.

Peter Shepard (23:49):

What you just described there, are factors that drive, it doesn't matter whether something is public or private there's shift to working from home is relevant. It's relevant for a lot of public companies, yes, is relevant for a lot of private real estate, certainly. And it's relevant for a lot of the venture capital that is exploiting these opportunities. So that's a factor. I think that's a great example of the type of factor that it's not going to keep to one asset class. That's the type of thing that really we should be looking for, where that shows up across the spectrum.

Brian Schmid (24:30):

The portfolio managers that focus on private assets, how to benchmark them. And so one question is, what index is used or what benchmark is used? Some typical ones that are used in the market are just, let's say an absolute return, a public index or listed index, plus some spread, or using a private data set like Burgiss, where you were actually benchmarking that portfolio manage, that portfolio to a portfolio of private assets. And then you could even take it even further that says, "Hey, I want to benchmark bond portfolio to private assets, but I want that benchmark to consider the constraints that I had in my portfolio, in terms of what asset classes I'm able to invest in, what size of funds do I have access to?"

Brian Schmid (25:23):

So it can go across the spectrum from, let's say, an absolute return hurdle to be from a benchmark perspective, to a customized portfolio of private assets is the appropriate benchmark for the privates piece. Second question is, what performance measure? We talked about the differences in the private markets in terms of the cash flows being not at your discretion, so what performance metrics do you use when you're just looking at the privates? And then finally the questions of, okay, once you decide on those two things, what methodologies do you need to use? We at Burgiss would recommend benchmarking a portfolio to a dynamically constructed portfolio of private assets, and benchmarking your portfolios performance relative to pooled calculations on that dynamically constructed benchmark. But that's when I'm looking at evaluating that portfolio manager within private assets.

Adam Bass (26:22):

We have strayed a bit and cross paths with the advanced private asset store, but as we find ourselves near in the exits, I think it would be helpful to turn to Peter once more for a final thought. Basically, what's the headline message here?

Peter Shepard (26:38):

Looking at private assets, not as a monolithic asset class at all, but as a bunch of different asset classes that are different from each other and share some similarities with public assets. Increasingly that's the direction that a lot of the most sophisticated asset owners are going in their asset allocation.

Adam Bass (27:00):

That's all for this week. Joe and I would like to thank our colleague Mary Hall for helping us bring this all together. And of course our thanks to Peter and Brian, and to all of you for listening. Next up on Perspectives, we welcome back Jitendra Vaswani, for our quarterly factors and focus check-in, including an in-depth look at value, and ESG as driver of risk and return. Until then, I'm your host, Adam Bass, and this is MSCI Perspectives. Stay safe.

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