INVESTMENTS & WEALTH MONITOR

A reprinted article from July/August 2022

Private Markets: Asset Allocation and Portfolio Construction

By Anthony B. Davidow, CIMA®

INVESTMENTS & WEALTH INSTITUTE®

Private Markets

ASSET ALLOCATION AND PORTFOLIO CONSTRUCTION

By Anthony B. Davidow, CIMA®

The private markets have grown to be an established portion of many institutional investor portfolios. The potential return enhancement, reduced volatility, and broad range of diversification options are compelling reasons why investors construct their portfolios to include these strategies.

—Bratkovich and Woo (2021)

Large institutions and sophisticated family offices have allocated large portions of their portfolios to private markets historically; until recently, it has been difficult for many high-net-worth (HNW) investors to access private equity, private credit, and real assets. In recent years, we have seen a growing demand for private markets by HNW investors, and a confluence of events has led to the growth of private-market funds.

The first is the growth and evolution of the registered fund market, making these investments available to HNW investors at lower minimums with more-flexible liquidity options. Interval and tender-offer funds have been around for decades, but it is only after the Global Financial Crisis (GFC) that these fund structures began to gravitate to private-market opportunities.

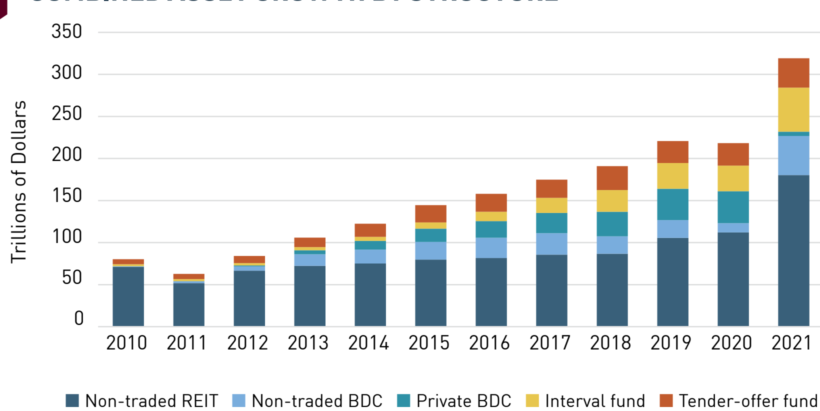
The growth of registered funds, available to accredited investors (AIs), has coincided with the introduction of new products being brought to the market by high-quality managers such as Blackstone, KKR, Hamilton Lane, Ares, Apollo, Franklin Templeton, and PIMCO, among others. As figure 1 illustrates, non-traded real estate investment trusts (REITs) represent the lion's share of the assets under management (AUM), but interval funds and tender-offer funds have been growing in AUM and number of funds since the GFC.

The prevailing market environment is the second factor that is growing the demand for private-market funds. Most capital market expectations (CMEs) are projecting substantially lower traditional U.S. equity returns during the next 10–15 years (4–5 percent versus the 10.2-percent long-term historical average); and fixed income yields are below their historical norms. Unfortunately, the correlations across most traditional asset classes have been rising due to the interconnectivity of the global markets, and inflation is at its highest level since the early 1980s.

Collectively, the market backdrop presents several challenges to both advisors and the investors they serve. The naïve 60/40 portfolio likely will fall short of achieving clients' expectations regarding returns, income, and risk reduction through diversification—and investors will see a dramatic reduction of their purchasing power due to inflation (Davidow 2022). Advisors need a more evolved toolbox to address the challenges of today's market environment.

Figure 1

COMBINED ASSET GROWTH BY STRUCTURE



Source: AI Insights, 2021

PRODUCT EVOLUTION

The first-generation private-market funds were structured as limited partnerships. The general partner of the fund received capital from investors—limited partners—and invested capital across a range of opportunities. Because it often took time to source and vet opportunities, investors committed capital that was drawn down through capital calls over time as opportunities were identified.

Traditional private-market funds, and feeder funds, are offered to a limited number of financially sophisticated investors (qualified purchasers or QPs)—mostly institutions and large family offices—and are not available to most HNW individuals. Because these investors are deemed to be more sophisticated, the funds are not required to register as investment companies under the Investment Company Act of 1940 or register their securities under the Securities Act of 1933.

Feeder funds were introduced to address the high minimum investments but, unfortunately, they are available only to QPs. Registered funds, including interval and tender-offer funds, are available to AIs. Note the structural trade-offs among the various structures (see table 1).

Investor eligibility. Traditional private-market funds and feeder funds are available only to QP investors, and interval funds and tender-offer funds generally are available to AI investors. Some registered funds use the qualified client criteria (see sidebar).

Minimums. Traditional private-market funds have very high minimums ($5 million), feeder funds have lower minimums ($100,000), and interval and tender-offer funds have low minimums ($25,000).

Capital calls. Traditional private-market funds and feeder funds are subject to capital calls as opportunities are sourced and capital is deployed. Interval and tender-offer funds do not have capital calls because money is invested upfront.

INVESTOR QUALIFICATIONS

Qualified purchasers (QPs) must have $5 million or more in investable assets not including a primary residence. Only 1.5 million people in the United States qualify as QP investors.

Qualified clients (QCs) must meet only one of the following criteria: $1.1 million or more of AUM with an investment advisor after making an investment in a registered fund, or a net worth of at least $2.2 million, excluding the value of a primary residence.

Accredited investors (AIs) need an annual income of at least $200,000 (or $300,000 in combination with a spouse) in each of the past two years, with a reasonable expectation of reaching the same income level in the current year. Alternatively, this status can be achieved with a household net worth of $1 million or more, excluding the value of a primary residence.

Cash drag. Traditional private-market funds do not have cash drag; capital is called from investors as it is needed and invested over time. Cash drag is the negative impact of holding liquid investments to meet redemptions. Feeder funds may have some cash drag. Interval and tender-offer funds will experience cash drag because they keep a portion of their assets liquid to meet redemptions. Note: Fund managers may try to mitigate the cash drag by investing in secondaries or more-liquid investments.

Tax reporting. Traditional private-market funds and feeder funds deliver K-1 tax reporting that is often late and may be restated. Interval and tender-offer funds deliver 1099 tax reporting, which is preferable to K-1 reporting.

Redemption/liquidity. Traditional private-market and feeder funds have limited liquidity and should be viewed as long-term investments (7–12 years); some liquidity may be available in the secondary market. Interval and tender-offer funds offer favorable liquidity. Interval funds are required to make periodic repurchase offers, at net asset value, of no less than 5 percent and up to 25 percent of shares outstanding.

With a tender-offer fund, the board of trustees of the fund offers to repurchase a set dollar amount of shares from shareholders during a certain time period. Tender offers enable investors to sell some of their shares back to the fund to receive cash proceeds. Most funds offer these tenders on a quarterly basis, usually limited to 5 percent of shares outstanding. Tender offers always are at the discretion of the board of trustees and therefore cannot be guaranteed.

Table 1

STRUCTURAL TRADE-OFFS

	Traditional QP Fund	Feeder Fund	Interval Fund	Tender-Offer Fund
Investor eligibility	QP	QP	AI or QC	AI or QC
Minimums	$5M	$100K	$25K	$25K
Capital calls	Yes	Yes	No	No
Cash drag	No	Limited	Yes	Yes
Tax reporting	K-1	K-1	1099	1099
Redemption/Liquidity	Limited	Limited	Quarterly	Quarterly (at board discretion)

Table 2

10-YEAR ANNUALIZED CAPITAL MARKET EXPECTATIONS (AS OF SEPTEMBER 30, 2020) BY ASSET CLASS

Asset Class	Expected Return	Standard Deviation	Past 20 Years Annualized Returns
U.S. Equity	5.4%	15.1%	5.9%
EAFE	5.3%	15.8%	3.3%
Emerging Markets	7.0%	20.4%	6.7%
Global REITs	5.7%	17.7%	10.7%
Global Infrastructure	5.6%	15.5%	8.0%
U.S. Government Bond	0.8%	4.3%	4.6%
U.S. Investment Grade	2.0%	5.6%	5.2%
U.S. High Yield	4.8%	9.1%	7.1%
Commodities	3.2%	15.0%	1.0%
Oil	3.3%	38.4%	0.0%

Source: 2021 Capital Market Expectations, Franklin Templeton Investment Solutions, September 30, 2021

ADVISORS NEED A BETTER TOOLBOX

The current market environment presents a challenging backdrop for both advisors and investors, and the outdated traditional toolbox likely will fall short of achieving investor goals. Advisors, therefore, need to expand their toolboxes to include a broader set of asset classes. Specifically, advisors need to identify sources of incremental returns, increased income, broader diversification, and inflation hedging.

Fortunately, through product evolution and a new wave of high-quality funds coming to the market, advisors can introduce clients to private-market funds (private equity, private credit, and real assets). Private markets historically have been valuable tools for institutions and family offices that allocated significant portions of capital to these illiquid investments in return for an illiquidity premium—the excess return received for locking up capital for an extended period of time (7–12 years) (Davidow 2021).

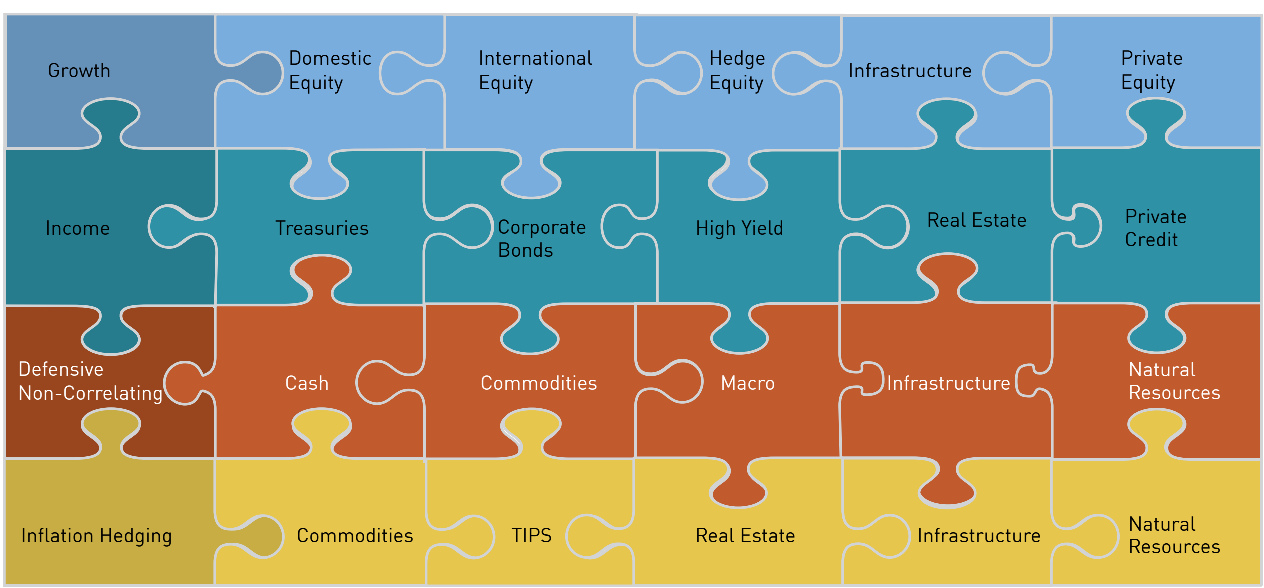
If we examine the CMEs from a select group of firms, we see they are projecting substantially lower traditional returns and more attractive returns for private markets. The lower CMEs are driven by the current economic environment and the expectations for much slower growth in the future (see table 2).

Private markets are versatile tools in building better portfolios. Private markets historically have delivered an illiquidity premium relative to their public market equivalents. Historically, private equity has delivered enhanced returns, private credit has provided an alternative source of income, and real assets have provided both diversification and inflation hedging. Private markets should not be viewed in isolation, however. Advisors need to consider how they can be used effectively in a diversified portfolio.

If we break down the various asset classes into the roles they play in a portfolio, focusing on the primary goals of growth, income, defense, and inflation hedging, we can see how versatile private markets can be in solving for investor needs (see figure 2).

Figure 2

THE ROLES OF VARIOUS ASSET CLASSES



ASSET ALLOCATION AND PORTFOLIO CONSTRUCTION CONSIDERATIONS

In contemplating allocating capital to the private markets, advisors should revisit their wealth management processes, beginning with the discovery process. What are the family's goals and objectives? What are the trust and estate issues? How much should be allocated to private markets? Which is the best fund given the family's constraints? How do you monitor progress relative to the family's goals?

HNW families may have multiple goals, across multiple account types, that they are solving for simultaneously. Advisors may need to consider the family's trust documents to determine the appropriateness of allocating to private markets, and they may need to amend the family's investment policy statement, including guidelines regarding the percentage allocations and liquidity guidelines.

Although private markets historically have delivered attractive return, risk, and correlation characteristics relative to traditional investments, there are several unique asset allocation considerations for advisors to consider before allocating capital.

Goals. What are the specific goals for the family? Do private markets increase the probability of achieving those goals?

Sophistication. Does the family understand the role of private markets in the portfolio? Do they understand the structural trade-offs, including fees, cash drag, and liquidity?

Investor eligibility. What type of fund is the family eligible to invest in (traditional private-market fund, feeder fund, or registered fund)? What are the structural trade-offs?

Time horizon. What is the family's time horizon? Private markets should be viewed as a long-term investment (7–12 years).

Allocation. What is the appropriate amount of capital to allocate? Is it all drawn down upfront?

Liquidity. What are the fund's liquidity features? Does it align with the family's time horizon?

Fees. What are the underlying fund fees? Do the fees create too high of a burden to overcome?

DUE DILIGENCE CONSIDERATIONS

As with any investment, an advisor must understand and evaluate the many dimensions of a fund (structure and strategy). Private markets are very specialized markets and they require experienced teams, deep resources, and strong internal controls to adequately source and deploy capital. The fund manager's experience and track record are of paramount importance when selecting a fund.

Unlike the plentiful tools for evaluating mutual funds and separately managed accounts, few databases exist for private-market performance, and there are some inconsistencies in the robustness and reliability of the data. Therefore, any data used should be supplemented by robust due diligence (investment, operational, and ongoing).

Given the short history of many registered funds coming to the markets, it is important to understand the track records of these funds' managers. Advisors may need to leverage due diligence conducted by headquarters and third-party providers. They should ask to review due diligence reports, if available, because the fund's prospectus may be limited in the information provided. Several key factors need to be considered, often referred to as the four Ps, but there are nuances with private-market funds:

Performance. Has the fund manager generated attractive returns across different economic cycles? Does the fund manager have experience managing private-market funds? What are the comparable absolute and relative returns? How much risk has the manager taken to generate the results?

Philosophy. Does the fund manager have a specific strategic view on the markets in which the fund intends to operate? Does it make economic sense given the current market environment?

Process. How are investment ideas generated, vetted, and executed? Who makes the decision? What resources are devoted to research and are they sufficient? Is the process applied consistently? What is the compensation structure?

People. Does the fund have a dedicated and experienced team of professionals? What are their professional qualifications? Have they worked together in managing comparable funds? Has there been a senior management turnover? What's the depth and consistency of the investment team?

Beyond the investment considerations, advisors also should evaluate several structural issues:

- What type of fund is being considered (traditional private equity fund, feeder fund, or registered fund)?
- What is the investor eligibility (QP, QC, or AI)?
- What is the minimum investment?
- What are the liquidity features?
- Does the fund exhibit cash drag?
- Does the fund have capital calls?
- What is the tax reporting (K-1 versus 1099)?
- What is the total fee (investment management, performance fee, acquired fund fee, etc.)?

In addition to the investment due diligence, professionals also should conduct operational due diligence (ODD) focusing on internal controls, finance and accounting, information technology and cybersecurity, and the use of independent auditors and pricing services. ODD can help in identifying red flags that require follow-up. Similar to traditional due diligence efforts, advisors also should conduct ongoing due diligence to ensure that the fund is managing capital consistent with the fund's stated approach.

CASE STUDY

To help illustrate the nuances of allocating to private markets across multiple account types consider the following case study:

John and Mary Jones are each 55 years old. John is an attorney and Mary is a tech executive, with incomes of $500,000 and $250,000, respectively. They have one son, John Jr., who is an investment banker, and three grandchildren. John and Mary have set up trust accounts for John Jr. and his children.

John and Mary have $8.5 million in savings, two homes, and no debt. Their primary goal is capital appreciation during the next 10 years. They plan to retire at age 65, when they will focus on their charitable activities (cancer research, protecting the environment, and financial literacy).

Based on this information, the Jones family is a good candidate for a private-market allocation. They have sufficient wealth, no immediate liquidity needs, experience investing in private equity, and their goal is capital appreciation. If we probe further, we learn that they have three different account types—personal investments, retirement assets, and trust accounts (see table 3).

Personal investments. John and Mary have $5 million in personal investments, with a primary goal of capital appreciation and a secondary goal of funding their favorite charities. They are investing to and through retirement, with a goal of growing their portfolio during the next 25 years. The recommended allocation includes tax-managed equities, fixed income, private markets, and cash. Because they are focused on growing their portfolio and have no immediate liquidity needs, their private-market allocation includes private equity and infrastructure.

Retirement assets. John and Mary have $1 million in retirement assets, with a primary goal of generating income and a secondary goal of distributions as they reach retirement age. The recommended allocation includes diversified equity exposure, fixed income, and private markets (no cash). Their private-market allocation includes private credit and private real estate, both alternative sources of income.

They have sufficient wealth, no immediate liquidity needs, experience investing in private equity, and their goal is capital appreciation.

Trust accounts. John and Mary have funded trust accounts for John Jr. and his children ($2.5 million), with a primary goal of accumulating wealth and a secondary goal of passing on wealth from one generation to the next. The recommended allocation includes diversified equity, fixed income, private markets, and cash. The private-market allocation includes private equity for growth, real estate for growth and income, and natural resources for diversification.

This case study illustrates the importance of understanding the various goals for each account type. It is worth noting

Table 3

CASE STUDY: JOHN AND MARY'S ACCOUNT TYPES

Personal Investments		Asset Allocation	
Investments	$5 million	Equity (tax-managed equities)	50%
Primary Goal	Capital appreciation	Fixed income	20%
Secondary Goal	Fund charities	Private markets (private equity and infrastructure)	25%
Time Horizon	25 years	Cash	5%
Retirement Assets		**Asset Allocation**	
Investments	$1 million	Equity (diversified equities)	50%
Primary Goal	Generating income	Fixed income	40%
Secondary Goal	Distribution	Private markets (private credit and real estate)	10%
Time Horizon	25 years	Cash	0%
Trust Accounts		**Asset Allocation**	
Investments	$2.5 million	Equity (diversified equity)	55%
Primary Goal	Accumulating wealth	Fixed income	30%
Secondary Goal	Provide for heirs	Private markets (private equity, real estate, and natural resources)	10%
Time Horizon	Multi-generation	Cash	5%

that none of the recommended allocations defaulted to the naïve 60/40 portfolio, and it is important to break down the private-market allocations based on the specific goals of each account type. With the proliferation of registered funds, advisors can evaluate discreet private-market exposures or diversification across private markets.

CONCLUSION

Today's market environment presents several challenges for advisors and investors, including lower returns and income, and higher correlations and inflation. Private markets are valuable and versatile tools in meeting the needs of HNW investors.

Fortunately, product innovation has made these investments more readily available to a larger group of investors at lower minimums and with more-flexible liquidity features. Registered funds have helped democratize the access to these elusive investments. Advisors need to evaluate the various funds coming to the market carefully, including the merits of the underlying investment and the structural trade-offs. Advisors who embrace private markets will have a more robust and multi-faceted toolbox.

Private markets are precise tools that can address specific portfolio needs, and some can fulfill multiple roles within a portfolio, where traditional stocks and bonds are blunt instruments. In a world where robo-advice threatens an advisor's value proposition, private markets represent a way for advisors to differentiate their practices and the expertise they provide.

Advisors can provide significant value to clients by using private markets effectively in building portfolios, increasing the likelihood of achieving clients' specific goals.

Anthony B. Davidow, CIMA®, is president and founder of T. Davidow Consulting, LLC, an independent consulting firm serving the needs of sophisticated advisors, asset managers, and family offices. He is chair of the Investments & Wealth Monitor *editorial advisory board. He earned a BBA in finance and investments from Bernard M. Baruch College. Contact him at tony@tdavidowconsulting.com.*

REFERENCES

Bratkovich, Tom, and Sarah Woo. 2021. Private Market Investing: Implications for Portfolio Construction. *Investments & Wealth Monitor* 36, no. 5 (September/October): 26–48.

Davidow, Anthony. 2021. *Goals-Based Investing: A Visionary Framework for Wealth Management.* New York: McGraw Hill.

——. 2022. Goals-Based Investing: Moving Beyond the 60/40 Portfolio. *Investments & Wealth Monitor* 37, no. 1 (January/February): 5–10.

INVESTMENTS & WEALTH INSTITUTE®

5619 DTC Parkway, Suite 600
Greenwood Village, CO 80111
Phone: +1 303-770-3377
Fax: +1 303-770-1812
www.investmentsandwealth.org