

Private Markets Mythbusters Series

You can't control the cycles, but you can control your nerves

Why a continuous investment strategy – especially in times of uncertainty – is the best remedy for volatile markets

After assessing the ability of private equity buyouts to generate returns across market cycles, we continue with our **Private Markets Mythbusters Series**, this time zooming in on periods of higher economic uncertainty and market volatility.

Despite investment data showing that strong performance in private markets often emerges from times of uncertainty, such periods appear to coincide – somewhat counterintuitively – with a reduction in investor activity that ultimately leads to investors missing out on returns, and obtaining lower diversification and less stable distributions.

This investment pattern might be the result of behavioral

biases rooted in the widespread myth that private market returns are pro-cyclical¹. Or even the consequence of investors being tied to overly restrictive (self-imposed or regulatory-driven) asset allocation frameworks and/or the lack of distributions seen during more volatile times.

In this paper, we will explain why periods of increased volatility can generate the most attractive buying opportunities in private markets. We will show how investors can take advantage of these opportunities by employing a simple playbook centered on investment

¹ Robinson, David T.; and Sensoy, Berk A., “Cyclicality, Performance Measurement, and Cash Flow Liquidity in Private Equity”, *Journal of Financial Economics* (December 9, 2015). Brown, Gregory; Harris, Robert S.; Hu, Wendy; Jenkinson, Tim; Kaplan, Steven N.; and Robinson, David T., “Can Investors Time Their Exposure to Private Equity?”, NBER (February 2020).

continuity and a flexible allocation framework. Using an example institutional investor portfolio and over 20 years of private markets cash flow data as a case study, we will also demonstrate how this approach can strengthen portfolio construction, as it results in improved performance and more stable distributions throughout market cycles.

Bad times, great returns

“History may not repeat itself. But it rhymes”. The quote often attributed to Mark Twain seems fitting for a comparison between the Global Financial Crisis (GFC) and the current uncertain macro regime.

2.6x

Post GFC
returns
achieved by top
buyout funds

Back at the height of the GFC, investor commitments to private markets dropped by approximately 60%. This was followed, however, by top managers delivering some of the best private equity vintages of the last two decades – 2.6x returns² for 2009 and 2010 vintages, compared to 2.1x for the six years before.

Fast forward to today and the latest fundraising data shows a c.30% decline from 2021 levels.³

Still, we believe it is important to emphasize that the current macro environment – defined by higher interest rates and sticky inflation, stricter lending

² Measured in Total Value to Paid-In Capital (TVPI).

³ Aggregate private capital fundraising as of December 2023. Source: Preqin (2023).

Crises yield good vintages

Global private equity fundraising and top-quartile buyout funds performance

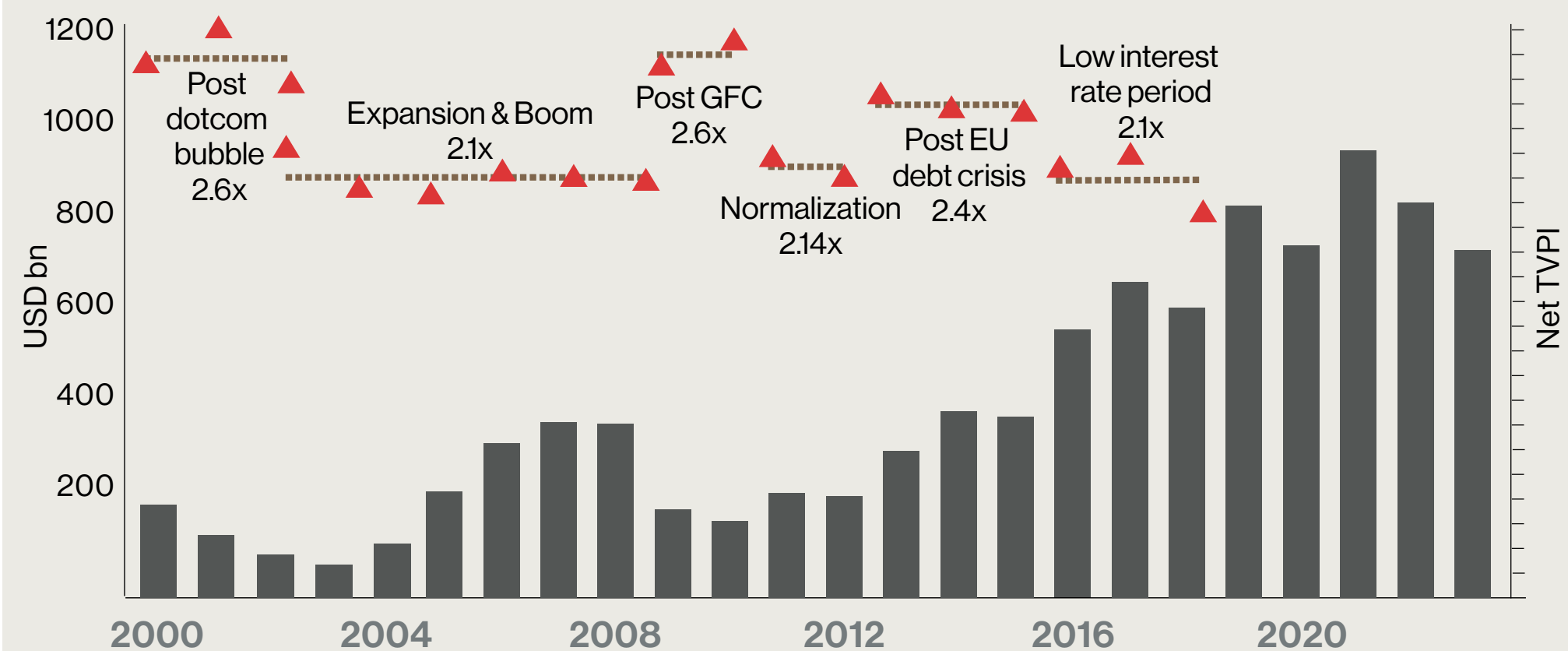


Chart shows global private equity fundraising in 2000-2023 and performance of top-quartile buyout funds measured by net total value to paid-in capital (TVPI). Sources: Partners Group (2024); market figures from Bloomberg as of 31 December 2023, Burgiss for net TVPI as of 30 June 2023, Preqin for Private Equity fundraising as of 31 December 2023. For illustrative purposes only.

standards, and uncertainty about a possible “soft landing” – is creating solid buying opportunities. In environments like this, buyers in private markets typically benefit from a range of factors, including:

- **Supply-demand imbalance:** coming under pressure from factors such as overallocation, fund maturity and liquidity issues, sellers are drawn to the negotiating table, which can give rise to a buyer’s market.
- **Illiquid markets’ transaction dynamics:** illiquid assets typically take longer to transact because of

due diligence, legal work, and the transfer of rights, among other factors. The fact that a sale is less likely to happen quickly can lead to additional discounts during periods of economic uncertainty.

- **Extended window of opportunities:** the best vintages do not emerge at the beginning of a crisis, but soon after. Looking at the secondaries market during the GFC, for example, we see that high-quality portfolios were sold at very attractive discounts in 2009 and 2010⁴ and not at the peak of the crisis.

⁴ Source: Greenhill Cogent and Jefferies.

Uncertain times require nerves of steel

Despite not intending to pursue a pro-cyclical pattern in their commitments, in reality, many investors are tied to the latest market developments when it comes to their investment decisions. Using simple regression analysis, a 1% drop in fundraising for a vintage year results, on average, in a 30 basis point return increase. This means that for 2023, which saw a c.10% year-on-year drop in fundraising from approximately USD 1.5 trillion to around USD 1.3 trillion, returns could increase by c.3%. The reality of the interplay between fundraising and returns is naturally more complex than that, but these numbers provide some interesting high-level insights.

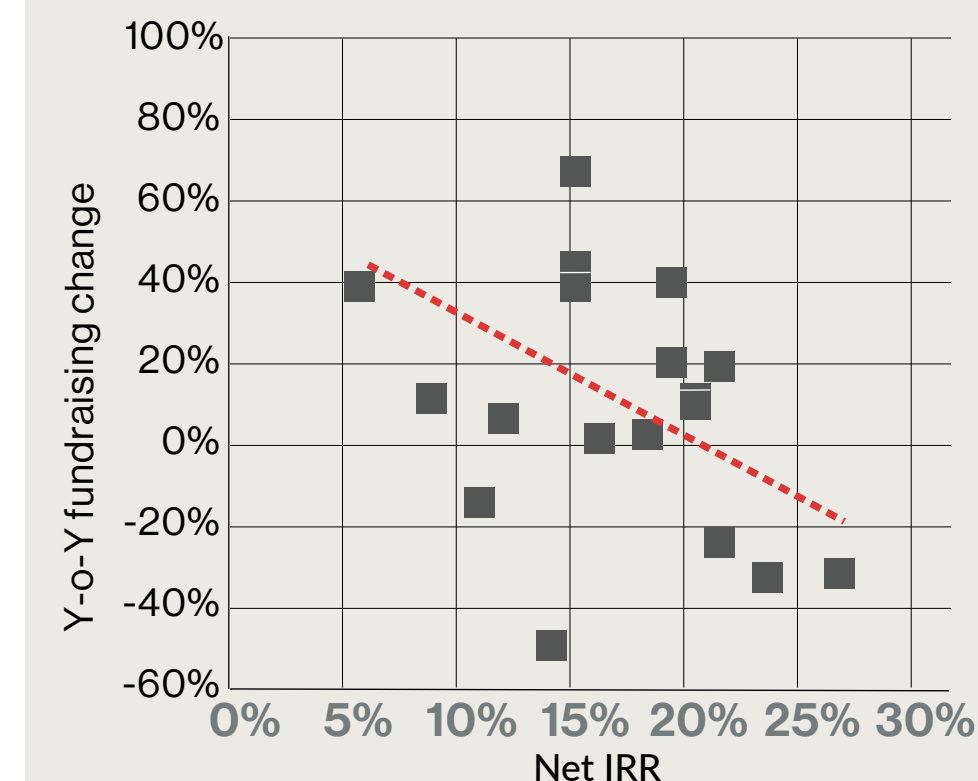
Anecdotal evidence points to pro-cyclical commitment patterns even among longstanding institutional investors. During the GFC, several high-profile institutions suspended private markets commitments, often citing these three main reasons⁵:

- **Performance concerns:** a widespread (and misleading) belief that private markets would underperform, leading to cuts in exposure.
- **Distribution levels:** with assets held for longer during periods of market stress, distributions to investors declined, making them reluctant to maintain or increase commitments.
- **Denominator effect:** with the plunge in public equity during 2008/2009, the relative share of private

⁵ See “Harvard: the Inside Story of Its Finance Meltdown”, Forbes, 26 February 2009; “Harvard endowment falls from \$36.9 billion to \$26 billion”, Harvard Magazine, 9 October 2009; Dan Lefkowitz, “Public/Private Markets”, Morningstar magazine, 13 October 2022; “The rise and rise of private markets”, McKinsey Global Private Markets Review 2018.

Lower fundraising, higher returns

Regression analysis of private equity fundraising volumes and returns per vintage year



Sources: Partners Group (2024); market figures from Burgiss for net IRR as of 30 June 2023, Preqin for Private Equity fundraising as of 31 December 2023. For illustrative purposes only.

markets investments within portfolios increased. Many institutional investors were forced to reduce or suspend new commitments.

Most of these concerns are still at play in the current uncertain environment, although the denominator effect is less of an issue today given the rise in public equity in 2023. To overcome this, we propose a simple approach that aims to bring clarity to a more complex investment environment and flexibility to handle constantly changing circumstances.

A simple, yet successful strategy

Drawing upon our experience in private markets portfolio construction built over more than two decades, we offer a strategy that is intuitive, proven and resilient to the unpredictable ebbs and flows of market cycles.

This approach is rooted in consistent commitments to every vintage. We believe this can deliver superior returns, while also improving diversification by vintage year and, as a result, enhancing liquidity. To successfully implement this strategy, however, investors require a more flexible framework around allocation targets.

With the following case study, we take an example portfolio and seek to demonstrate how our approach performs better over time than two of the most

common commitment strategies. We will assess these strategies against returns, liquidity and their ability to fit within allocation guidelines.

Case study of commitment strategies

Portfolio characteristics:

- USD 1bn invested from the year 2000.
- 25% allocated to private markets and 75% to public markets.⁶

⁶ Private markets allocation: 60% private equity / 15% private debt / 25% real assets; public markets allocation: 60% equity / 40% fixed income. Private markets allocation calculated as NAV from historical buyout vintages since 2000; public markets exposure based on the total return of an initial USD 750m investment. First data point: 01/01/2000 throughout, except for private infrastructure (available from 2012). Returns calculated as IRR since investment start for different strategies. Private markets strategy is based on net cash flows derived from the Burgiss dataset. Distributions from the private allocation are only made after capital calls have been serviced and if there is a minimum of 2% cash buffer in the private markets portion of the

- The private markets portfolio consists of a portfolio of private markets funds based on the Burgiss database, with net cash flows constantly reinvested.

This set-up is applied to the following strategies:

Constant Commitments: the same amount is invested every year, adjusted for inflation, and set to target a 25% private markets exposure.

Market Commitments: this resembles the deployment of an investor committing in line with the deployment pace of the industry.

portfolio. Burgiss dataset: Equity, Debt, Real Estate. Public market portfolio: Global Equities (MSCI World Net TR USD, NDDUWI Index) and Global Bonds (Bloomberg Global Agg., LEGATRUU Index). To provide full transparency, we have conducted this case study entirely using the Burgiss data set. Adding direct, co-investments as well as secondaries content can further enhance the forthcoming results. Further information available on request. Source: Partners Group (2024), Burgiss, Bloomberg.

Rigid Net Asset Value (NAV) Targeting: the investor follows a hard NAV targeting approach, seeking a 25% exposure to private markets and reducing or increasing commitments whenever the allocation exceeds or falls below the NAV target.

Results

As illustrated by the chart on the left, our analysis shows that the Constant Commitments strategy strongly outperforms the other private markets strategies, as well as the classic 60/40 public markets portfolio. The approach generates a performance uplift of 150bps, taking the private markets portfolio to a 14% net internal rate of return (IRR), compared to the 12.5% obtained by the Market Commitments approach.⁷

Compounding at 14% per year, the Constant Commitments strategy achieves a 6x total value to paid-in capital (TVPI) versus c.4x for the other private markets strategies. This is driven by the steady compounding of every vintage year and a more stable distribution profile in the Constant Commitment strategy.

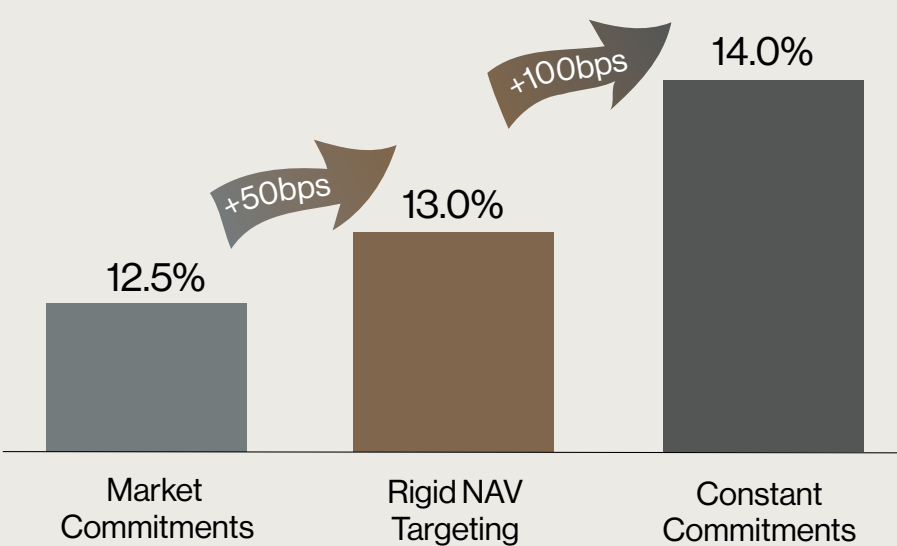
On top of this, a 25% Private Markets allocation increases the net return of a 60/40 portfolio of 4.2% by around 250bps per year to 6.7%. Overall, that's a 60% performance increase.

Through our analysis, it has become clear that both the Market Commitments and the Rigid NAV Targeting strategies lead to pro-cyclical allocation patterns by design, not realizing the full

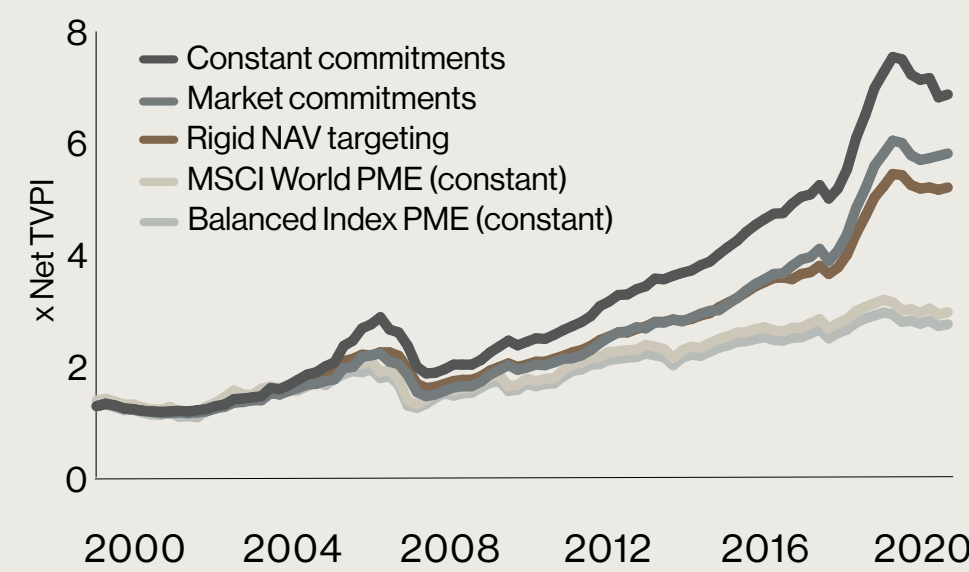
⁷ There is no assurance that similar results will be achieved.

Consistent and higher Returns comparison across different commitment strategies and public markets

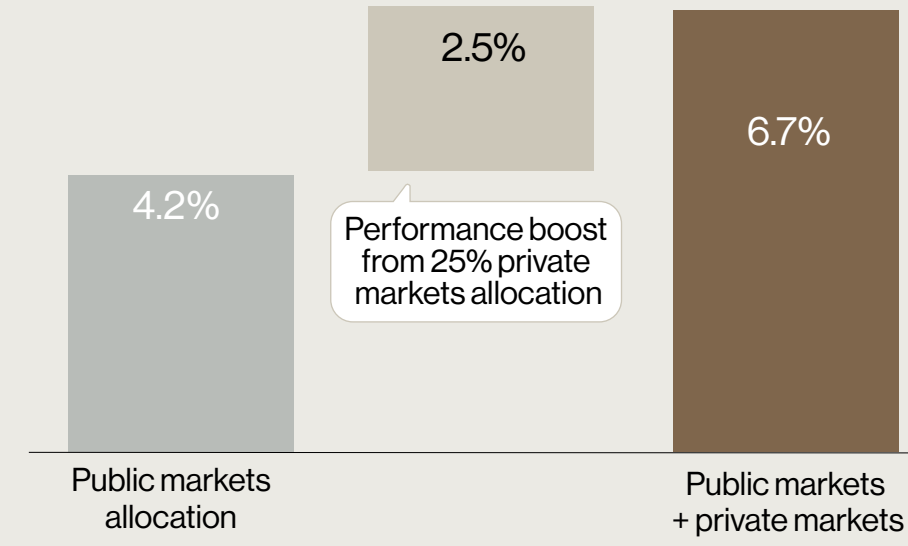
Net IRR uplifts from commitment strategies



Private markets strategies vs public markets



Uplift from private markets addition to portfolio

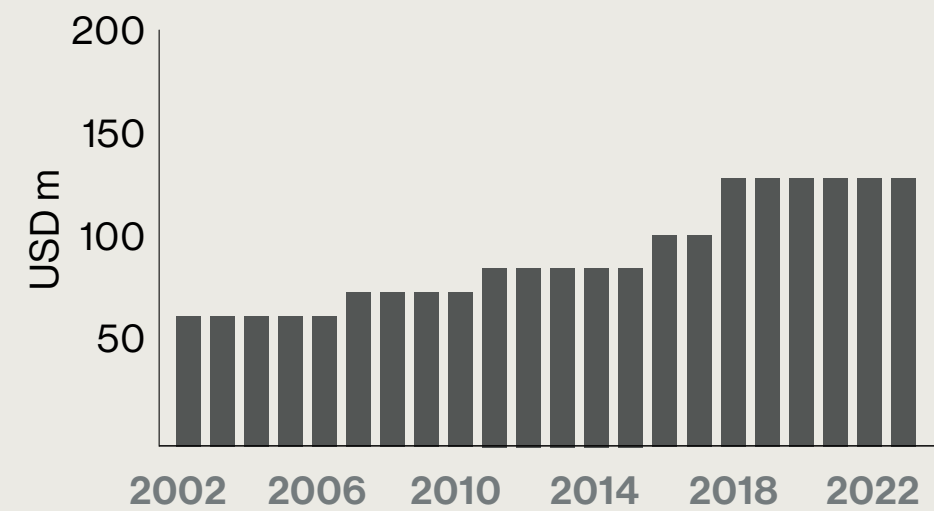


All calculations based on the commitment strategies described before and evaluated as of 30 June 2023 with investments starting in 2000. Balanced Index PME and public markets portfolio taken as 60% MSCI World (NDDUWI Index) and 40% Bloomberg Global Agg. (LEGATRUU Index). IRR SI for buyout only, with similar results for other asset classes. Net IRR based on Burgiss data for 2000-2019 evaluated as of 30 June 2023. For illustrative purposes only.

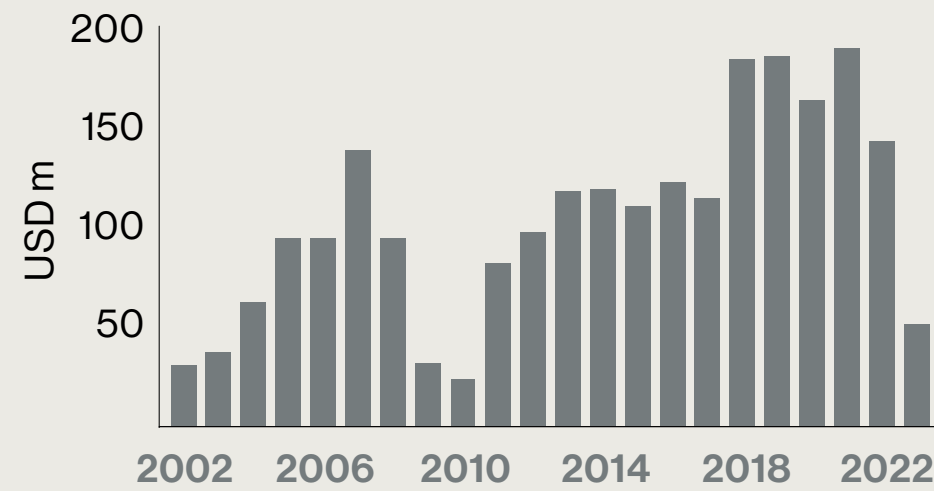
Commitment fluctuations

Amount committed per year under each strategy

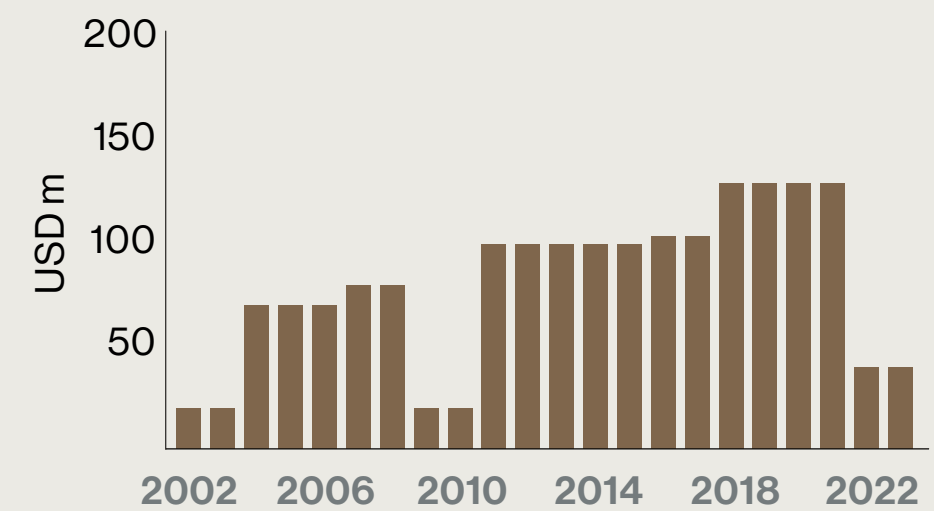
Constant Commitments



Market Commitments



Rigid NAV Targeting



Source: Partners Group (2024). For illustrative purposes only.

potential of private markets in a portfolio. Besides the impact on returns, these patterns generate imbalances in diversification by vintage year, which will ultimately affect distributions and liquidity and even exacerbate potential issues with the denominator effect.

The Market Commitments strategy is marked by prolonged periods of over-allocation, often followed by sharp reversals, resulting in a more volatile allocation profile over time. In turn, the Rigid NAV

Targeting strategy offers a more stable allocation profile, yet – if applied “dogmatically” with no active portfolio management – it can create significant gaps in vintage year allocation due to a “stop-and-go” pattern in commitments.

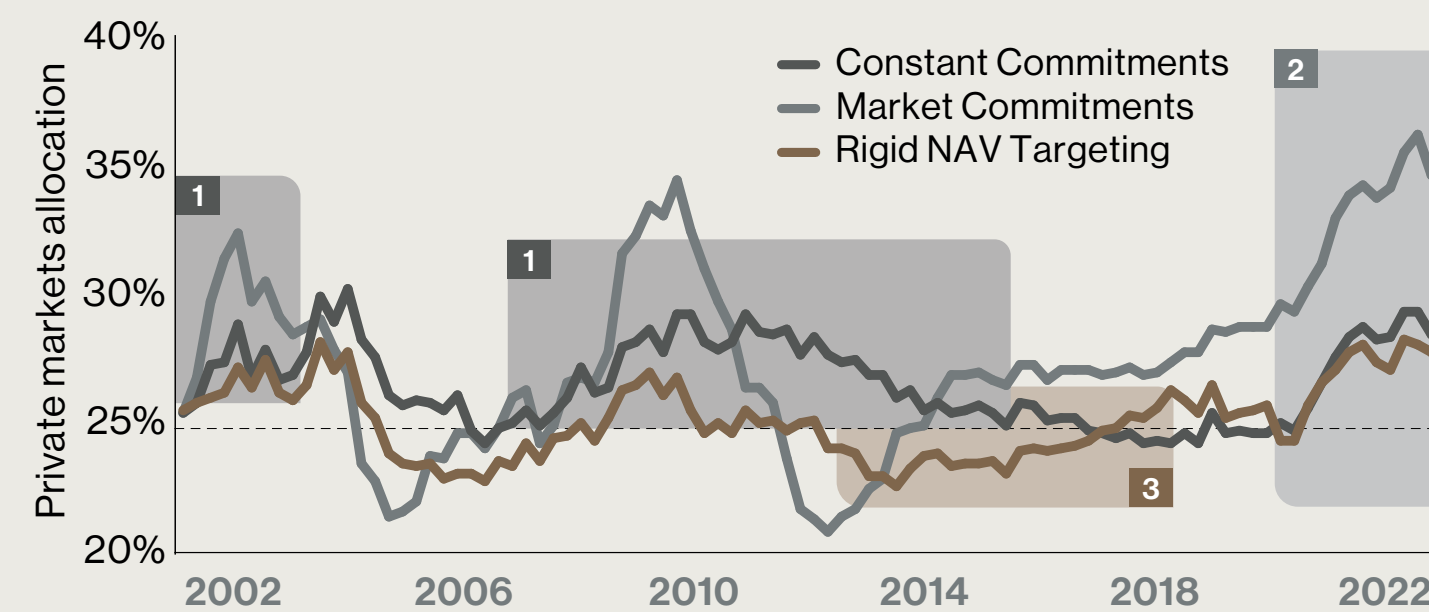
On the other hand, the Constant Commitment strategy delivers a more balanced diversification by vintage year, with greater cash flow stability and enhanced liquidity. As the comparison of vintage year exposure shows, it also enables investors to not miss

out on the most attractive vintages (like 2009/2010) and avoid concentration (like in 2012/2013).

We note, however, that investors would need a greater degree of flexibility in their asset allocation framework to apply this strategy. This means having the ability to remain nimble and deviate from target levels by c.5% for periods of up to three or four years in order to harvest the full benefits of their private markets portfolio.

Keeping up with the allocation target

Variation in private markets allocation as % of total portfolio

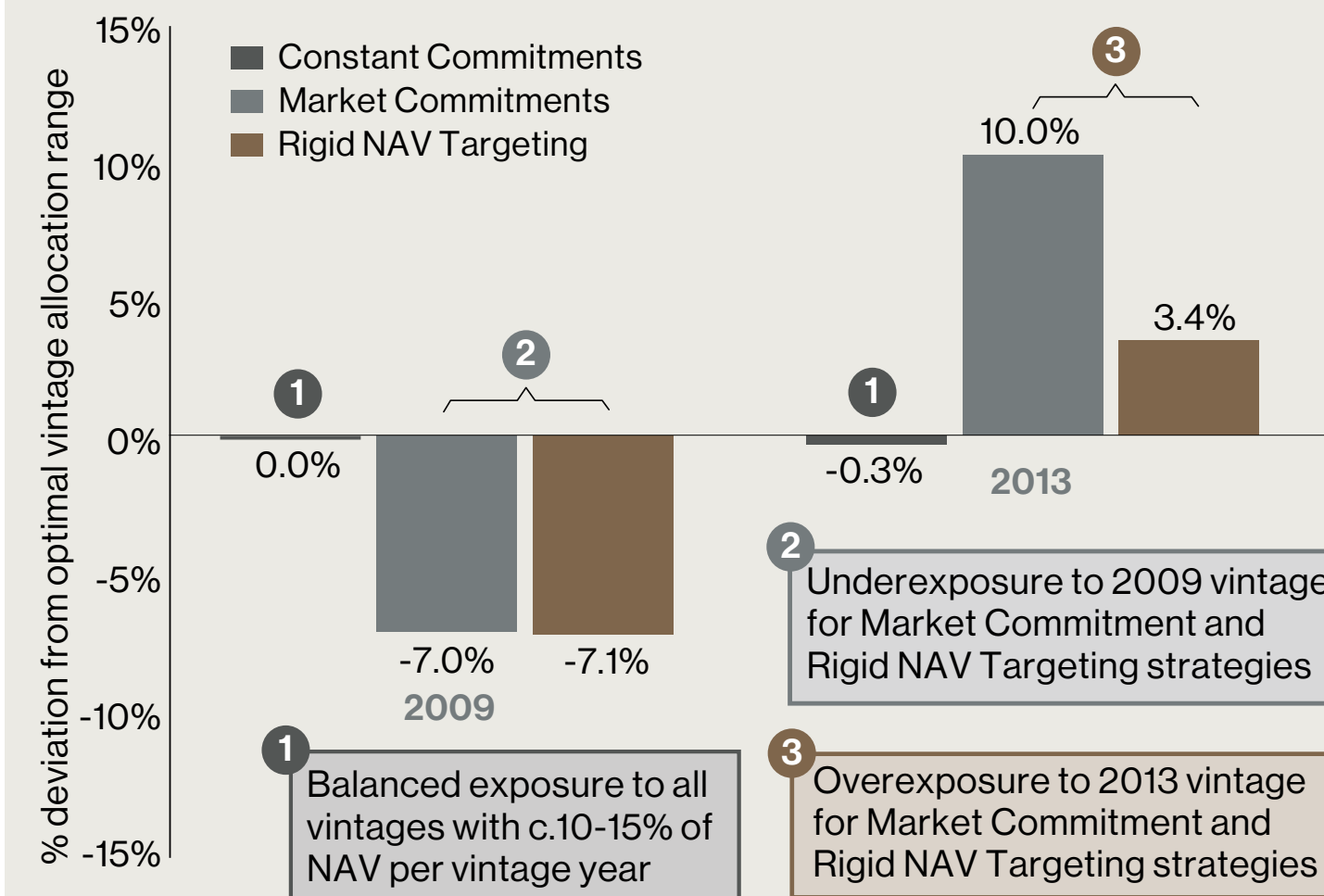


- 1** Constant Commitments: slightly longer period of overshooting, but less exposure overall
- 2** Market Commitments: exhibits the widest swings due to market sentiment-driven commitment pattern
- 3** Rigid NAV Targeting: close tracking of target exposure led to lower commitments to 2009/10 vintages, which had attractive performance

All calculations based on the commitment strategies described before and evaluated as of 2023 with investments starting in 2000. Source: Partners Group (2024), Burgiss, Bloomberg.

Vintage balancing

Deviation from optimal vintage year exposure as % of NAV for selected vintages



All calculations based on commitment strategies described before and evaluated as of December 2015. Optimal vintage year exposure range fixed at 10-15% per vintage. Source: Partners Group (2024), Burgiss. For illustrative purposes only.

Keep control and choose your tactics

In a volatile economic environment like today's, we believe it pays off to keep control of one's nerves. By staying disciplined, investors can navigate market cycles effectively and take advantage of the opportunities arising from moments of dislocation.

Implementing a Constant Commitments strategy, however, is not an easy task. Simply investing in closed-end funds or funds of funds will not suffice, as in the end these funds will always retain control of deployment and inherently result in a more inflexible investment tool for clients.

To properly execute a Constant Commitments strategy, investors need the ability to access individual transactions ("direct" investments) across asset classes to ensure flexibility; an extensive investment platform that can generate robust investment flow to ensure diversification; and access to other instruments such as secondaries to take advantage of market cyclicalities and add further diversification.

This can be achieved through a bespoke mandate solution, managed by specialist portfolio managers who have the necessary experience and tools to implement such a strategy.

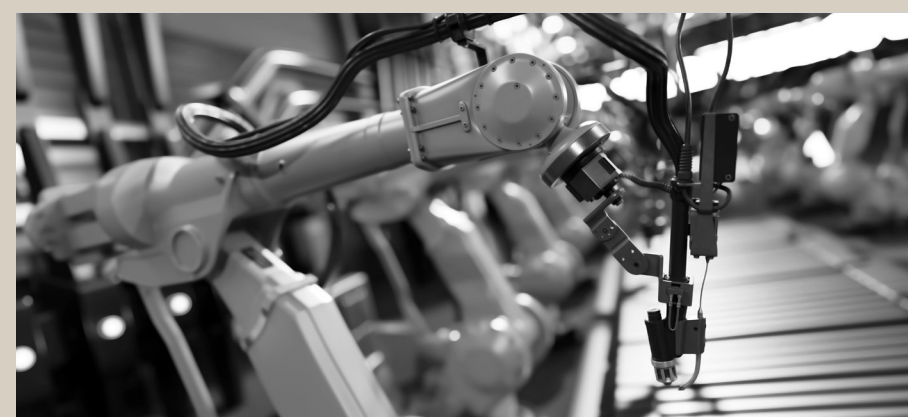
As a more uncertain macro regime imposes itself, constant commitments and a flexible investment framework can make the difference between taking advantage of the opportunities created by market volatility, and watching them pass by.

Next time in our *Private Markets Mythbusters Series*

While applicable to any private markets investors, the ideas discussed in this paper are particularly relevant to those following an evergreen investment approach through open-end funds, which are inherently exposed to various market cycles.

As these structures rise in popularity, our next paper will take a closer look at their characteristics, with a view to equip investors with the tools to discern among the various offerings in the market and tackle the nascent misconception that all evergreen funds are created equal.

Subscribe here to receive the next papers in our Mythbusters Series.



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