



Getting the Best out of Private Markets Portfolios

Tackling today's investment challenges with yesterday's options may create more challenges than it solves. To achieve target returns, investors may need to update their toolkits.

The starting point for any project is making sure you have the right tools for the job, and it is a rule that applies just as much to investment as to anything else. Unfortunately, there is a risk that today's private markets investors are trying to build 21st century portfolios using last century tools.

Over the last 25 years, both public and private markets have evolved and may now be on the brink of a step change. The familiar economic and investment environment that has sustained markets since the Global Financial Crisis may be about to give way to something rather less forgiving.

The first evolving change has been the decline in the number of public companies in the US, which has fallen by 50% in the last 25 years. Recent S&P data suggests there are only 2,600 public companies with revenues exceeding USD 100 million vs. nearly

17,000 private companies of this size. By this measure, we believe most investors are structurally underweight to private markets investments and are not accessing the significant premium we believe is critical to meeting return objectives.

The underlying factors behind this trend are still playing out and investors who do not address the imbalance in their portfolio will face ever greater uncertainty in their investment outcomes.

But this imbalance also creates significant opportunities for private markets investors. Not only is there a large number of companies open to investors, but private markets also offer a huge spectrum of highly differentiated businesses and assets across a range of markets and sectors. This means investors will be able to find the opportunities best suited to their own unique needs and objectives.

In other words, the widest range of choice for investors now lies in private, rather than in public markets.

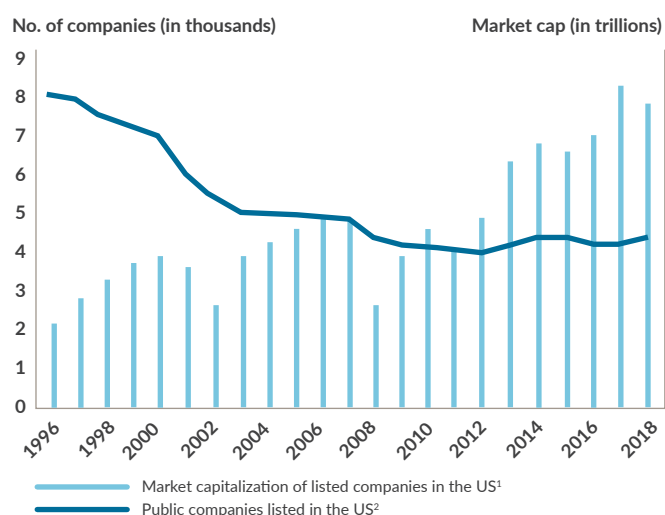
On top of this steady shift towards fewer public and more private companies, we are now on the verge of a fresh development – a change in central bank policies.

Since the Global Financial Crisis, central bank stimulus has pumped liquidity into markets. While often dubbed the 'Fed Put', this liquidity injection has been a feature of central bank policies around the world. That excess liquidity, easy borrowing, and excess leverage, combined with a significant growth in passive investing and declining numbers of public companies, has led to a great imbalance in supply and demand.

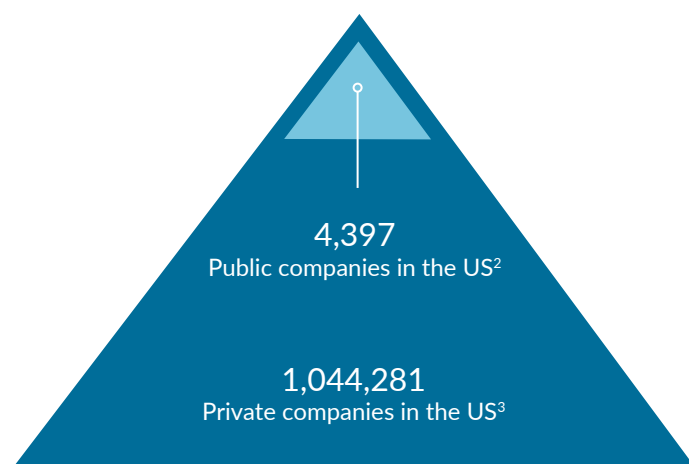
This has led to risk asset prices spiraling ever upwards. The era of central bank liquidity is, however, drawing to a close. ➤

Public markets may not offer the breadth of options they did 25+ years ago

No. of public stocks in the US has declined by 50% since 1996

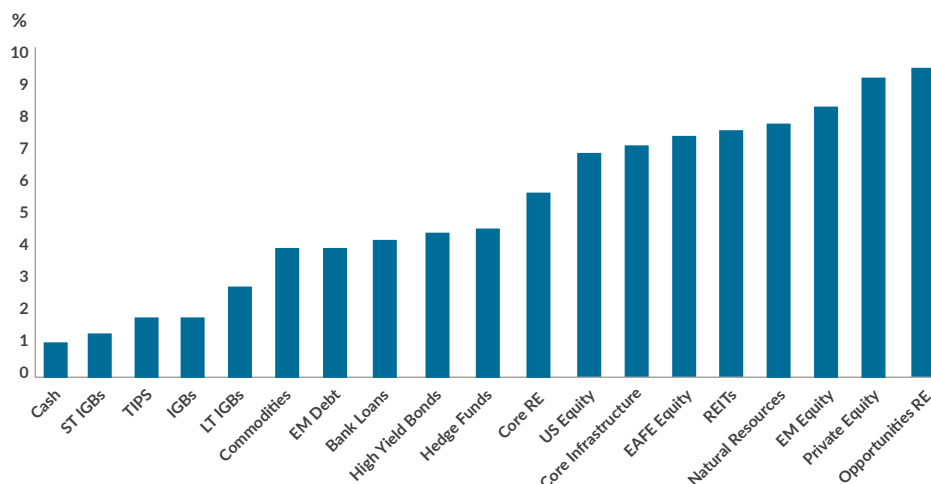


23x more private companies than public in the US



Source: 1. The World Bank, Market capitalization of listed domestic companies, 2021. 2. The World Bank, Listed domestic companies, total - United States, 2021. 3. Private companies with 2,500 employees and higher, US Census Bureau, May 2021. Please reference <https://www.census.gov/naics/#q2> for definitions of private companies and their sectors. For illustrative purposes only. Partners Group, January 2022.

Long-term outlook: 20-year annualized expected returns



Source: Meketa Investment Group's 2020 Annual Asset Study.

➤ As central banks start to taper the enormous amounts of liquidity injected into the markets, the supply of liquidity will become more variable and public markets will be more susceptible to substantial shocks from both macro and micro factors. The end of the 'Fed Put' means investors will no longer be able to count on intervention to support rising asset prices.

With these dynamics in place, we believe private markets will outperform public markets. It is a view supported by recent capital market projections.

Investors have faced a daunting challenge over the last 30 years to generate sufficient returns. In 1991, investors could achieve a

7% annual return largely through fixed income and cash. It was almost unnecessary to invest in return-seeking assets to achieve this target.

Today, investors seeking the same 7% annual return must build a portfolio that is 97% return-seeking assets, with portfolios of far greater complexity and with far greater volatility. In fact, to achieve that same 7% return, investors today must expose themselves to 16x more volatility than in 1991.

This creates a significant challenge for investors who must now choose between three distinct paths:

- Continue a random stroll and hope for the best;
- Count on diversification to carry the day;

- Invest with a more precise and active approach.

We believe the third option is the only rational way forward.

What will drive outperformance in private markets?

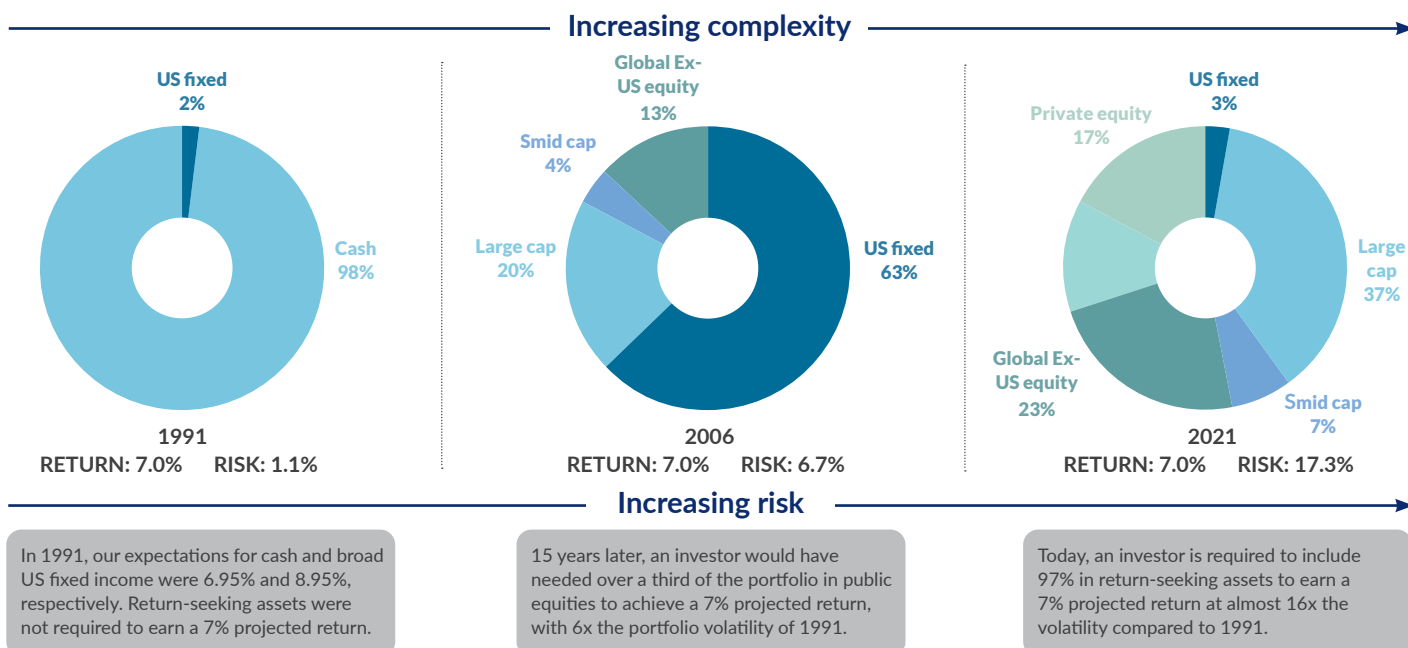
Investors should not accept the average or median projected returns of the respective asset classes and should instead aim to do better. We believe four factors are critical in driving outperformance:

1. Adopt a flexible approach that is open to opportunities across private markets asset classes depending on relative value;
2. Use deeper insights into the risk/return profile of investments to optimize exposure;
3. Be willing and able to drive value and create outcomes within individual investment opportunities;
4. Capitalize on the benefits of active management and entrepreneurial governance, which are more prevalent in private markets.

Many institutions' investment strategies are driven by the need to meet liabilities, and to meet these goals they are turning to riskier assets. But as investors typically commit pro-cyclically to private markets funds, they are increasingly doing no more than tracking the performance of this asset class. They are adding beta (matching the market) rather than pursuing more alpha (outperformance). The result is that their portfolios will be unlikely to generate the expected returns.

This approach is in effect backward-looking, and, in terms of matching liabilities, leaves investors largely chasing their own tails. ➤

7% expected returns over 30+ years



Source: Callan, 2021. There is no assurance that similar investments will be made. Past performance is not indicative of future results. Diversification does not ensure a profit or protect against a loss. For illustrative purposes only.



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› We believe allocators will need to be more active in the management of their private markets portfolios. In doing so, they will need to be closer to the investments (businesses, buildings, assets) and make better informed decisions about how to position their exposures.

At Partners Group, we believe investors must navigate two substantial hurdles to meet their goals. The first is to overcome the cyclical challenges of investing in private markets. This means taking advantage of opportunities as they become available and adopting flexible asset allocation that can capture inefficiencies across a business cycle.

The second is to find the optimal structure that minimizes the inefficiencies of investing in the asset class. There has been little innovation in the traditional closed-end fund over the last 40 years. Investors need

to re-think their processes and find more efficient ways to invest on behalf of their beneficiaries to capture additional performance through more bespoke solutions.

The underlying forces that are reshaping markets have been underway for some time, but we are now at a significant juncture. The time is ripe for investors to adapt to the markets of the 21st century, address the opportunities in private markets and do so with innovative structures, detailed and precise analysis, and a flexible approach.

Over the coming weeks, we will be publishing further thoughts and analysis on:

- Evergreen funds: the next frontier for private markets investors?
- Hitting the sweet spot in diversification
- Active management and driving outcomes. ■

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Partners Group is a leading global private markets firm. Since 1996, the firm has invested over USD 170 billion in private equity, private real estate, private debt and private infrastructure on behalf of its clients globally. Partners Group seeks to generate strong returns through capitalizing on thematic growth trends and transforming attractive businesses and assets into market leaders. The firm is a committed, responsible investor and aims to create sustainable returns with lasting, positive impact for all its stakeholders. With USD 127 billion in assets under management as of 30 June 2021, Partners Group provides an innovative range of bespoke client solutions to institutional investors, sovereign wealth funds, family offices and private individuals globally. The firm employs more than 1,500 diverse professionals across 20 offices worldwide and has regional headquarters in Baar-Zug, Switzerland; Denver, USA; and Singapore. It has been listed on the SIX Swiss Exchange since 2006 (symbol: PGHN).

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