Private markets for endowments and foundations
What are private markets?

Private markets refer to investment strategies for companies that are not traded on a public exchange or market. They can have equity or fixed-income characteristics and cover a wide range of investment approaches with different risk and return profiles.

What is private equity?

Private equity can be defined as investment in equity (or equity-like securities) that is not tradeable on public markets. It includes several sub-categories, and private markets also encompass strategies involving bond-like securities.
Viewing the life cycle of a company in terms of its ability to generate cash flow, private markets cover a continuum of investment strategies that can be ordered as follows:

- **Venture capital** begins with early-stage, pre-revenue companies and extends through to late-stage investing, when a company develops a product and begins generating revenue.

- **Growth equity** is the next phase, when the risk shifts from whether a product will work to whether it can gain market adoption. The companies that own such products might not be cash-flow positive at the point of investment, but would be expected to be so at the point of realisation.

- **Buyouts** of stakes in cash-flow-generating companies. Buyouts may target companies of any size. Larger companies are typically considered safer and more stable, with broader diversified cash flows, but this is often reflected in higher valuations.

- **Mezzanine debt** funds provide a means to finance buyouts with subordinated debt (unsecured loans or bonds that rank below other, more senior loans or securities). Mezzanine funds also tend to have equity co-investments (minority investments made directly into an operating company alongside the private equity investor).

- **Distressed and turnaround** strategies usually involve companies that have gone into decline or are underperforming.

- **Special situations** cover just about everything else involving unlisted assets, including private credit strategies, and asset-backed and infrastructure investments.

**Chart:**

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**Note:** For illustration and educational purposes only. Fund managers are for illustration only, and this chart should not be considered as an endorsement or recommendation, nor should one construe that investors will have access to these groups now or any time in the future.
Private market funds

Private market funds are set up via partnerships in which the fund managers are known as General Partners (GPs) and the investors are known as Limited Partners (LPs). These partnerships usually have a seven- to ten-year initial life span with possible annual extensions.

LPs commit to invest a given amount. Most of the committed capital is called down during the investment period — typically the first three to five years of the fund’s life — and subsequently invested in non-listed assets. The later years of the fund’s life are characterised by incremental investments in these assets. Ultimately, liquidity events are generated, as investments are realised and capital as well as profits returned to the LPs.

A growing opportunity set

Although accessing private markets remains difficult for many investors, the asset class is becoming increasingly hard to ignore as it represents a growing share of the opportunity set for investors. According to the 2021 McKinsey Private Markets Annual Review, private market assets under management (AUM) grew by 5.1% in 2020 to reach US$7.3 trillion, an all-time high.

By net asset value, global private equity (by far the largest sub-segment in private markets) has grown by a factor of nearly 10 since 2000, outpacing growth in public equities market capitalisation nearly threefold over the same period according to the McKinsey review. Growth rates for private markets net asset value and public market capitalisation first diverged during the global financial crisis, and that divergence has accelerated over the last decade.

The McKinsey report also shows that, although private equity still represents the largest percentage of private markets, the range of investment opportunities has also expanded, offering investors diversification opportunities across a range of investments with different characteristics, as described above.
Why are private markets investments appropriate for endowments and foundations (E&Fs)?

A key characteristic of private markets, and one that often acts as a deterrent for building an allocation to the asset class, is their illiquidity — that is, the fact that they tie up a portion of investors’ assets for a number of years. However, GPs use this longer-term horizon to generate substantial value by transforming portfolio companies, providing a “value added” premium over public markets.

E&Fs are established to fund charitable and non-profit institutions, including universities, hospitals and charities, generally with the aim of doing so in perpetuity. They are therefore well suited to such long-term investments as they generally have a long-term investment horizon in order to maintain their mandate into perpetuity. This enables them to be rewarded for their ability to tolerate that illiquidity and capture the potential value-added premium it confers.
Why are private markets investments relevant to E&Fs?

The short answer is because private markets can provide exposure to return drivers that are not available in liquid markets. These return drivers might be attractive either because they offer greater compensation for risk (the value-added premium), or because they are expected to provide a different return profile from other parts of an investor's portfolio (diversification benefits).

E&Fs generally have an annual spending rate above the inflation rate, which requires them to focus on the best long-term opportunities to reach their target return. Private equity commonly has the highest expected returns of both traditional and alternative investments, and can play a key role in achieving higher total portfolio returns. The best-performing E&Fs generally have an allocation of at least 15% to private markets, and that allocation has been growing steadily over time.

Looking beyond private equity, the broad range of other private markets investment opportunities brings several additional attractive features which further enhance portfolios. Specifically, these features include inflation hedges (infrastructure, real estate), low correlation to other asset classes (infrastructure, real estate, private debt) and reliable income streams (infrastructure, real estate, private debt).

How much of their assets should E&Fs allocate to private markets?

In order to answer this question, E&Fs need to be clear on their need for liquidity. A helpful first step can be to undertake a “liquidity budgeting” exercise, which should provide clarity around the extent to which they can tolerate illiquid assets within their strategy. This exercise will consider the cash-flow needs of the organisation over time, its requirements for short-term liquidity to meet the funding of grants, projects and running expenses, and the impact on asset allocation flexibility due to illiquid holdings. This exercise will necessarily be organisation-specific; results will vary from company to company.

For reference, the average allocation to private markets of US endowments was 22.8% of their total assets in 2020, and 25.6% for endowments with portfolios exceeding US$1 billion (source: Nacubo-TIAA Study of Endowments).
Why should E&Fs consider investing in private markets now?

In an environment of rising yields from exceptionally low levels and low- to moderate-risk premia, we believe investors increasingly need to look beyond traditional liquid asset classes (equities and bonds) in order to generate meaningful returns. In particular, investors should be open to the potentially attractive and diversifying return sources available in illiquid asset classes (private markets).

It is generally acknowledged that traditional portfolios, dominated by equities and bonds, have performed exceptionally well through the disinflationary environment over the last decade. But the returns to be achieved from listed markets over the coming years are likely to be lower.

At the beginning of this year, we forecast a strong economic recovery after the COVID-19 health crisis. We still expect the global economy to recover; however, the Russia-Ukraine crisis has added significant uncertainty and may dampen the recovery rate. Rapidly tightening monetary policies — a consequence of resurgent inflation — also increase the volatility risk, while valuations for growth assets leave little room for error.

The first half of 2022 has made it clear that elevated equity valuations are prone to downside risk from negative surprises or headlines. With rising inflation fears, US markets initially fared worst among the major regions due to their high weighting to long-duration growth stocks. The Russia-Ukraine crisis and the resurgence of COVID in China then changed the pecking order, with European and emerging markets becoming the worst-performing ones. Rapidly rising interest rates around the world are now negatively impacting most markets. In this environment, many investors are turning to private markets to boost expectations for future overall portfolio returns.
Conclusion

Private markets remain a complex and hard-to-access asset class — but it is one that is increasingly hard to ignore, given its growing importance in the economy as well as in institutional investors’ portfolios. However, the most compelling reason for incorporating an allocation to private markets in a portfolio is to enhance its return potential and diversification, especially given the muted return outlook for traditional asset classes. E&Fs are particularly well suited for such investments, bearing in mind their generally high return objective and long-term investment horizon.

For institutions that do not have the size or resources to tackle the complexities of investing in private markets, Mercer offers a complete best-in-class solution, leveraging its significant expertise and resources in this asset class. As Mercer is a global leader in responsible investing and ESG, this solution has the further benefit of integrating such considerations across all the different sleeves, with the additional option of a sleeve specifically focused on impact investments.

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