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Private Markets Whitepaper

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To discuss your requirements
+44 (0)20 3327 5600
info@camradata.com

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Welcome to CAMRADATA's Private Markets Whitepaper

Once a niche part of institutional portfolios, private market investments are gaining traction with investors of all shapes and sizes. Along with the traditional favourite of real estate, investors are making increasingly significant allocations to infrastructure, private equity and debt, and increasingly sophisticated portfolios of blended credit and alternative loan books.

For example, according to McKinsey's annual survey of the sector in April 2021,[1] global private equity assets under management had already reached $4.5 trillion in the first half of 2020—growing 6% from year-end 2019, or an annualised 16.2% since 2015. The consultant expected more to come.

Along with clear diversification benefits of allocating to a whole host of new asset classes, what have been the main drivers of this surge into private markets?

A paper by The Bank of International Settlements in December 2021 claimed "private markets have become an important financing channel for the real economy, especially in North America and Europe".[2] On the one hand, it cited a specific need for yield following the financial crisis of 2008/9; on the other it noted that the real economy – that not centring on listed companies, their equities or bonds – had also a significant need for growth and supportive capital.

Underpinning all of this is a powerful need for innovation within institutional portfolios, married with a genuine thirst for sustainability. Can private market assets enable investors to engage with and promote a sustainability agenda, which encompasses both risk management and a growing range of investment opportunities, better than public ones? And where do investors see the next stage of the private market evolution taking place?

[1] https://www.mckinsey.com/~/media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/mckinseys%20private%20markets%20annual%20review/2021/mckinsey-global-private-markets-review-2021-v3.pdf

[2] https://www.bis.org/publ/qtrpdf/r_qt2112e.htm

Private Markets Roundtable

The CAMRADATA Private Markets Roundtable took place virtually in London on 9th March 2022.

" WTW portfolio manager Ed Hails says his firm had been a long-time user of private assets, as doing so fits with its diversification strategy. There had been a modest increase on what he describes as a reasonably high base already among their portfolios."

Private market investments, such as real estate, infrastructure, private equity and private credit have recently gained traction among institutional investors. In part, this is because they offer access to sectors and companies that are not available via public means, they avoid some of the volatility that troubles listed securities and they can potentially generate greater returns.

This paper discusses the driving forces in private markets, the challenges and opportunities facing the sector, and how those operating in the sector can find sustainable investing prospects.

We began by asking participants, each of whom work in or with private markets, if they recognised a growing interest in their sector.

WTW portfolio manager Ed Hails says his firm had been a long-time user of private assets, as doing so fits with its diversification strategy. There had been a modest increase on what he describes as "a reasonably high base already" among their portfolios.

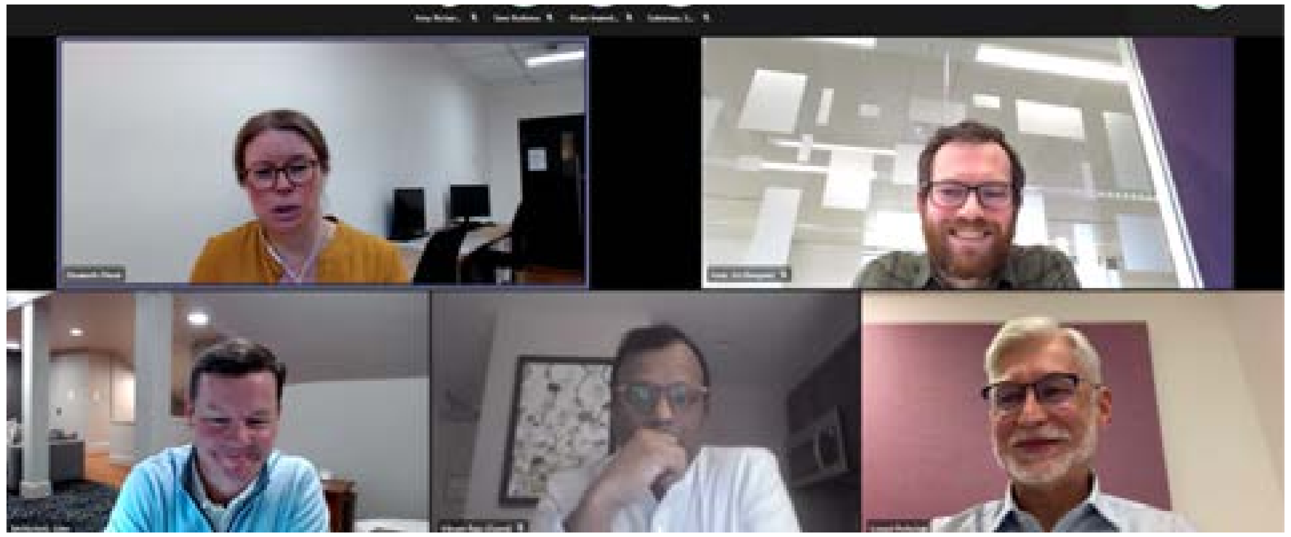
Away from WTW's own clients, Hails reflects that the broader market had likely seen a moderate increase in private market use. He says the use of private assets would be highly dependent on investors' circumstances, their chosen time horizon and tolerance for illiquidity. This is particularly the case for defined benefit (DB) schemes, which may be close to the end of the journey plan and subsequently thinking about, or currently, de-risking.

Lorant Porkolab, trustee director at LawDeb, is more convinced private assets in general are being more widely adopted by DB schemes. "The trend is obvious, at least in relation to UK DB pension schemes, that the allocation to various different assets in private markets has been steadily increasing, and the growth in that area – at least in my view – has been one of the most interesting and prominent developments in the institutional investment world over the last decade."

Real estate is one of the more traditional areas in private markets and one that institutional investors are typically more comfortable and familiar with, comments Porkolab. However, he has recently seen an increase in allocation to private credit and private equity too.

"Private credit can become a very important component in an investment strategy and it should be part of the journey planning considerations for pension schemes, as the associated contractual incomes can be used very well when pension schemes are thinking about risk reduction, matching liabilities, and benefit payments. Private equity is obviously a riskier asset class and it would play a very different role in the portfolio, but it's another area where we have seen an increased interest. Trustee boards are getting more comfortable with some allocation to private equity, not just to private credit," he adds.

The market trends spotted by the panellists hold up to scrutiny. According to McKinsey's annual survey of the sector in April 2021, global private equity assets under management had reached $4.5trn in the first half of 2020 – a 6% increase from the end of 2019, or



" The level of sophistication in private markets, the ability to take a long-term view and make the capital trade-offs needed, the increased amount of deal flow – all that will lead to a substantial breaking away in performance between public markets and private markets."

an annualised increase of 16.2% since 2015.

Opportunities

The panellists appear united behind the thesis that private markets provide investors with diversification benefits.

WTW's Hails highlights that investors increasingly need to opt for private markets to invest in certain sectors and companies that cannot be found in the public arena.

"In particular, venture capital and early-stage growth companies have to be done privately, [and] there are broad areas of private debt markets that you can't necessarily get exposure to through public equivalents," he says.

In addition, the opportunity to add value through alpha is one that presents itself through private markets. "Very, very active owners are given a different opportunity to create value, and that is a diversifying return," he adds.

LawDeb's Porkolab agrees, adding that private assets offer a very good variety of investment options, providing diversification even within the asset class, in the form of real estate, infrastructure, direct and asset-backed lending funding arrangements across different geographies and so on.

"That variety is now more available to institutional investors, which can bring significant diversification benefits."

One of the obvious differences between private and public markets, is investors' visibility of the minute-by-minute performance of their investments. Stock exchanges are public, and news is widely reported when markets dip or climb. For private markets, there are no such updates, and as a result, private markets are less volatile.

For pension scheme trustees, according to Porkolab, this can be both a good and a bad thing. On the one hand, not being exposed to daily valuations and volatility could be considered a benefit of private assets. On the other, it could be argued that company valuations are not market tested. This raises some questions and challenges about transparency, market efficiency and, of course, liquidity.

"This was perhaps one of the reasons for the certain healthy level of initial resistance from pension funds to invest in these assets," he adds.

But John McNichols, Managing Director and Head of Multi-Asset Strategy Portfolios at Barings' Private Asset Group, argues the lower volatility associated with private assets is intuitively appealing to investors.

"Historically, you see the actual volatility of credit returns measured by credit losses, not market value changes, to be fairly low compared to public markets. Because of the nature [of the asset] you tend to have better security, better structuring and you have more of a partnership between borrower and lender. Historically, you have higher recovery rates, so not only do you get an illiquidity premium, but you also lose less money," he explains.

These are just a few of the elements that make private markets a "premium product", according to Vikram Raju, Head of Impact Investing (Private Markets), at Morgan Stanley Investment Management. One of the main benefits is the potential for additional returns.

"It's been very hard with public markets on a tear," he says. "But I think the level of sophistication in private markets, the ability to take a long-term view and make the capital trade-offs needed, the increased amount of deal flow – all that will lead to a substantial breaking away in performance between public markets and private markets."

investing is a premium product. The nature of the relationships between investors and their companies are different in private markets, and more conducive to finding good, long-term solutions to create value."

McNichols returns to the key factor of the illiquidity premium, offered by private markets, and how they could also give investors exposure to a wide range of companies, sectors and assets.

Porkolab agrees, adding: "[With some private assets], you are giving up liquidity and you are compensated for that with higher returns. Similarly, you tend to access a more complex universe of investment options, and you are expected to be rewarded for that complexity and a higher level of sophistication."

With all that said, the wider use of private markets could spell good news for investors willing to consider these alternatives, aiming to increase diversification and access higher yields and returns.

The LawDeb director says the number of funds in the market has increased significantly, and that the market is becoming more efficient, which could also reduce costs for institutional investors.

"As the efficiency increases, and players become more comfortable with all sorts of market dynamics, costs will come down – but we can't expect them to come down to the same level associated with passive listed investments," he adds.

"Private market investing is a premium product. The nature of the relationships between investors and their companies are different in private markets, and more conducive to finding good, long-term solutions to create value."

Challenges

Although private assets make sense for some DB schemes – depending on where they are in their journey – the same may not apply to defined contribution (DC) schemes, which are closer to investors and can be considerably smaller than their DB counterparts. McNichols says there may be liquidity challenges with private markets and DC schemes.

"Offering 'X' percent of liquidity on a periodic basis is theoretically possible, but I can see circumstances in which that would be difficult to do. Making sure investors are aware of those limitations and what the impact could be on their liquidity is a key concern of mine."

WTW's Hails, meanwhile, points out smaller DC plans do not necessarily have the resources to invest in what he describes as "sophisticated ways", as private investing comes with a hefty price tag. However, he explains that master trusts are becoming increasingly common in the UK pensions space, which could help to solve this problem.

"There are some challenges around investing in private markets for DC, and costs and fees are a big part of that. Master trusts are a key part of the solution, as they are big enough to have the resources to invest in a much more sophisticated way," Hails adds.

Cost of doing business

It is no secret that private assets are not the cheapest option available to investors. For example, the ongoing charge levied by the average investment trust in the Association of Investment Companies private equity sector is just over 1.7%, excluding any additional performance fees. This compares to an average of 0.84% among investment trusts in the AIC global equities sector, excluding performance fees.

However, panellists believe that going private is worth the extra cost.

For McNichols, private investing's more substantial price tag is reasonable because of the returns offered by the sector.

"Private asset management services are more expensive, [and] it costs more for us to provide an origination platform that is robust. In addition, public market investors pay a bid-ask spread in the market, so their 'platform costs' are, to some extent, subsumed into total returns that are lower than they otherwise might be. Private market

Sustainability and private markets

Investing sustainably is a conversation taking place in both public and private markets. As with investing in public companies and funds, there is no agreed standard on what constitutes as environmentally friendly, sustainable or 'ESG-friendly' for private markets. As a result, it is up to asset managers operating in the sector to obtain relevant data and make a judgement

Raju explains his team's process: "Our screen for looking at things we'd like to invest in starts with; Is it sustainable or not? Are they interesting businesses that need capital which will grow and give us a great return?"

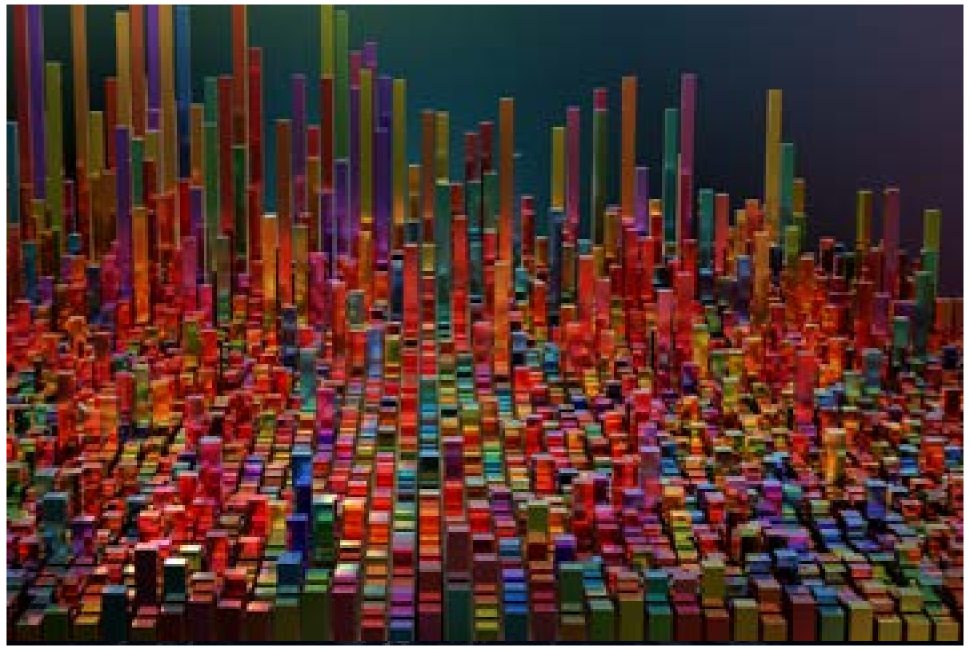
"The question we ask ourselves is, is there something fundamental about the product this company has, or the process by which it develops a product, or the service it provides, that has some implied environmental benefit? And if that's something that strikes us as being plausible, then we go and carry out due diligence on that company."

Despite lack of access to standardised documentation and data, it is not a challenge for private asset managers to get their hands on relevant information, Raju says, because the potential investee is motivated to produce relevant information in the hope of obtaining private capital.

"At that point, they are giving us every bit of information they can get their hands on, or hiring consultants to get that information," Raju continues. "If they want our capital, if they share our vision on where this company needs to go, and if they want to capture some green premium at exit, they're going to want to do everything we ask of them – and that's the beauty of private markets."

The impact investing head suggests, regardless of whether they want to explicitly label themselves as 'sustainable', it is to the benefit of private managers to pay attention to sustainability because it can help a growing company and increase returns.

"Recycling reduces the cost of goods sold; it reduces the risk of supply chain disruption," Raju says. "Weather-proofing your supply chain ensures goods aren't sitting in a flooded basement, leaving you unable to fulfil orders for two quarters losing market share as a result."



Considering the revenue part of the equation, Raju notes the premium sustainable products can attract, which can add significant margin.

"I don't know if this greenium is going to last. But if you don't have all these things in place, you will trade at a discount. [Sustainability] is becoming mainstream because it's unavoidable."

LawDeb's Porkolab, however, is not as convinced there is appetite to drive sustainability among all private equity investors.

"Private equity is an area where owners have the option to influence decisions and drive the business towards sustainability, look at the underlying sustainability characteristics, set key objectives, renumeration and so on, accordingly. But that's just one segment of the private equity industry and just one segment of private market assets. For instance, if you are a private credit investor or manager, you don't have the same level of influence about corporate objectives and strategy."

He continues: "Similarly, certain types of private equity will not necessarily focus on sustainability. If you think about some of the oil majors and energy companies selling some of their brown assets, there is a significant private equity interest in those assets."

Looking ahead

The CAMRADATA panel on private investing closed by asking panellists what they believe is next for private markets, and how private assets can blend into a wider portfolio.

McNichols concludes investors are likely to look for increased diversification within their private asset portfolio. This would not necessarily or only be to increase returns, but rather to diversify their assets, which would be a good thing for portfolios more broadly.

"Over the past 30 years, the influence of private equity generally has been increasing in the economy," he says. "As private equity has grown in influence, it has also grown in size and scope. That has all kinds of impacts on the economy and the financing markets as well. Privately owned entities are more likely to source private funding on the credit side, for example."

For McNichols, the real richness and variety has – and may continue to be – come on this private credit side.

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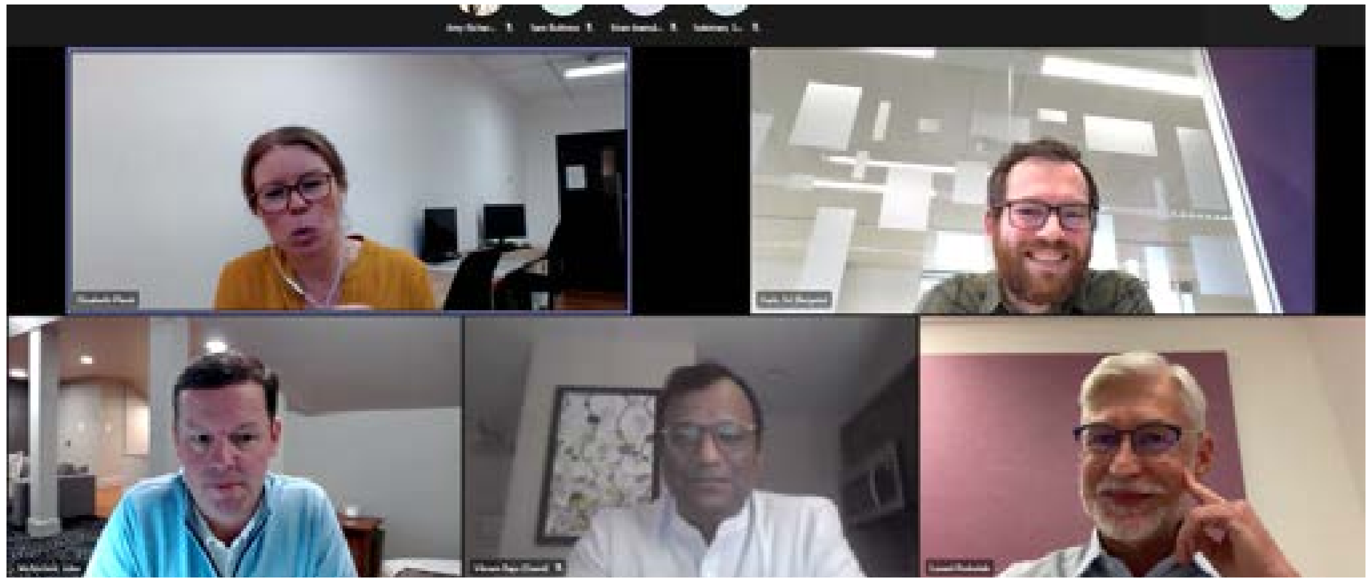

"There are attendant benefits, including speed, customisation and cost," says McNichols. "While you may pay a little more on the interest rate side, you're going to have other benefits that help you manage your company in a better way."

A great variety of origination sources that have searched for capital have found partners as investors have broadly accepted private markets into their portfolios.

"Big picture – that's driving a lot of the growth in the complexity and the size of private markets generally," says McNichols.

WTW's Hails agrees, adding: "Why have a private debt mandate focused on just one [area] when it can be broader, with a similar return, but lower risk. Alternatively, specialists could be used in each of these areas."

He continues: "We have clients that restrict us to private equity, but where they don't, how we would construct a high-returning private markets portfolio would be between two-thirds and three-quarters private equity, and the rest of it will have high-returning real estate, infrastructure, natural resources, and private debt strategies. These are similarly returning to the private equity funds... but it's a much broader, more diversified, more robust portfolio."

Porkolab agrees this strategy could be adopted more widely, but cautions it would depend on the specific circumstances of the investor. He says there may be some pension funds that start with more of a bespoke, 'do-it-yourself' approach to private assets, and

> ***" I hope three years from now, when we have a panel, we're not talking about sustainable investments, but just talking about investments because the entire approach is sustainable."***

then gradually shift to more of a total-portfolio approach, and this decision may depend on the lifecycle of the pension scheme, maturity profile and end-game strategy.

Regarding the future of sustainability in private assets, Morgan Stanley's Raju adds: "I hope three years from now, when we have a panel, we're not talking about sustainable investments, but just talking about investments because the entire approach is sustainable."

Roundtable Participants

John McNichols

Managing Director

Personal Profile

John McNichols is the Head of Multi-Strategy Investing for Barings' Private Asset Group, responsible for the management of private multi-strategy portfolios, assessment of relative value between private asset classes globally, and the commercialization of Barings' private multi-strategy capabilities. John has worked in the industry since 1992. Prior to joining the firm in 2017, he was Principal with IGV Management LLC.

Before IGV, John worked at Fidelity Investments, first as Managing Director of High Yield Research, and subsequently as SVP, Head of Product Management. Prior to Fidelity, he worked at Standish as Portfolio Manager and Head of Credit Strategies. He has additional experience with Jefferson-Pilot Life Insurance Company and First Union National Bank. John holds a B.A. from Davidson College and an M.B.A. from the University of Michigan.

Barings

Company Profile

Barings is a $382+ billion* global investment manager sourcing differentiated opportunities and building long-term portfolios across public and private fixed income, real estate, and specialist equity markets. With investment professionals based in North America, Europe and Asia Pacific, the firm, a subsidiary of MassMutual, aims to serve its clients, communities and employees, and is committed to sustainable practices and responsible investment.

*As of June 30, 2021

Vikram Raju

Head of Impact Investing

Private Markets

Personal Profile

Vikram Raju is a Managing Director and Partner responsible for Climate Impact and Emerging Markets for AIP Private Markets where he also serves on the Investment Committee. He has 24 years of relevant industry experience. Prior to joining the firm, he was the Climate Funds Lead at the World Bank Group (IFC).

Previously, Vikram was a management consultant with McKinsey & Company and a portfolio manager with Lazard Frères. From 2019-21, Vikram served as the Chair for the Impact Council at EMPEA (Emerging Markets Private Equity Association). He is currently a member of the Morgan Stanley Investment Management Sustainability Council and serves on the GenderSmart working group on Gender and Climate.

Vikram received degrees in Economics and Finance from Bombay University and in International Affairs at Columbia University. He holds the Chartered Financial Analyst designation.

Morgan Stanley Investment Management

Company Profile

Established in 1975 as a subsidiary of Morgan Stanley Group Inc, Morgan Stanley Investment Management has provided client-centric investment and risk-management solutions to a wide range of investors and institutions for more than 40 years.

Our investment teams strive to provide strong investment performance, excellent client service and a comprehensive suite of investment management solutions to a diverse client base, including governments, institutions, corporations and individuals worldwide.

In March 2021, Morgan Stanley completed the acquisition of Eaton Vance, including its market-leading affiliates Calvert Research and Management and Parametric Portfolio Associates LLC, allowing the Firm to bring even more value to clients through an expanded array of diverse and complementary investment offerings across public and private markets.

Roundtable Participants

Lorant Porkolab

Director

Lorant is a Trustee Director at Law Debenture, working as a professional independent trustee on a number of UK pension schemes. He is a very experienced corporate finance and pensions professional. He joined LawDeb in September 2021 following his 10-year term as Partner and Head of Covenant Advisory Services at XPS Pensions Group.

Prior to that Lorant worked in various roles at PricewaterhouseCoopers, Hymans Robertson and Mercer. He advised both trustee and corporate clients on funding defined benefit pension schemes, focusing on pension strategy, corporate transactions, covenant assessments, and negotiation support.

Lorant is an Accredited Member of the Association of Professional Pension Trustees (APPT). He is also a CFA® Charterholder with a PhD in Operations Research who spent the early years of his career in academia, lecturing both at Imperial College and the London School of Economics.

Ed Hails

Portfolio Manager

Ed is a Portfolio Manager in WTW's delegated investment team, managing total fund and specialist private market portfolios for UK and overseas pension funds. Ed also chairs WTW's global Private Markets Portfolio Management Group and is co-portfolio manager for WTW's UK and Euro Secure Income Funds.

Ed has worked for WTW since 2008, after studying mechanical engineering at the University of Bath

Moderator

Elizabeth Pfeuti

Chief Client Officer

Former Dow Jones staffer Elizabeth Pfeuti is Rhotic's Chief Client Officer and a member of the Rhotic Media executive leadership team. A highly-decorated journalist, Elizabeth has been in financial journalism for around 15 years. At Dow Jones, she covered the asset management, investment banking and investor services beats for Financial News, where she also wrote on a wide range of regulatory themes.

She was previously the European Editor for CIO Magazine and boasts an exceptional contact book of buy-side and in-house institutional CIOs and asset management executives. More recently she has worked on corporate briefs for pension consultants, investment banks and asset management groups.

Meet the Team!

Sean Thompson

Managing Director

Natasha Silva

Managing Director, Client Relations

Amy Richardson

Managing Director, Business Development

Sam Buttress

Associate, Business Development

Mithursha Kesavan

Database and Publication Support Associate

Sarah Northwood

Marketing and Events Coordinator

CAMRADATA
5th Floor, 11 Strand,
Charing Cross, WC2N 5HR

+44 (0)20 3327 5600
camradata.com

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