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Private Markets—From Alternative to Mainstream: Evolution during the Past 30 Years and Key Trends and Challenges for the Decades to Come

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Overview

In ***Private Markets—From Alternative to Mainstream: Evolution during the Past 30 Years and Key Trends and Challenges for the Decades to Come***, from the June 2022 special 30th anniversary issue of ***The Journal of Investing***, Erik Knutzen (of **Neuberger Berman**) explains the dramatic growth and evolution of private markets since the 1980s. Back then, private equity (PE) was a small and exotic sector for only the most sophisticated investors. In the decades since, however, PE has grown into a multitrillion-dollar global industry that owns thousands of companies, while the number of publicly listed companies has dropped to about half of what it was in the 1990s.

The author explains the key drivers of these events: regulatory changes, the evolution of credit markets, broader acceptance of PE among institutional investors, PE's relatively high returns, growth and innovation in the PE sector, PE's diversification and return-smoothing benefits, PE's better alignment for long-term investors, and the fact that private markets are becoming more liquid. Private markets likely will continue to grow due to PE's higher expected returns, institutional investors' need to close the "return gap" between expected and target returns, and the fact that PE is increasingly grouped with traditional assets in asset allocation frameworks.

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Key Definitions

Private equity (PE)

PE is a class of investment funds that primarily buys ownership shares in private companies that are not listed on any stock exchange. PE firms solicit funds from institutional investors such as pension funds and universities. PE is not available to the general public, and so it is not subject to the same regulations or reporting requirements as publicly traded investments. This frees PE managers to use alternative performance measures and to choose with whom they share performance data.

Private investments

Private investments consist of assets that are not traded on any exchange and are not available to the general public. These include private equity (PE), which are investment funds that buy companies for the purpose of restructuring them, improving their performance, and reselling them at a profit. The private investments in which endowments invest are mainly PE, venture capital (investments in startup companies), and private real estate.

Public market equivalent (PME)

PME is a performance measure that indicates the performance of a fund relative to a given benchmark index. PME is calculated as the sum of all discounted cash flows from the fund to investors, where the discount rate is the total return on a public equity index. A PME of greater than 1.0 indicates that a fund outperforms the benchmark index; a PME of less than 1.0 indicates that a fund underperforms the benchmark index.

Practical Applications

- **Private markets have grown dramatically over the past 30 years and now are becoming part of mainstream investing.** Over the same period, the number of publicly traded companies dropped by about half.
- **Key drivers of the growth of private markets are PE's higher performance, looser regulations on private companies, and the evolution of credit markets beyond traditional banks.** PE also has become better aligned with the goals of long-term investors because of the increasingly short-term focus of public markets.
- **As institutional investors attempt to close the gap between expected public-market returns and the target returns they need, they will continue to allocate to PE, and private markets will continue to grow.** PE has the highest projected returns of all major asset classes in most capital market assumption frameworks.

Discussion

In the 1980s, private equity (PE) was a small and exotic investment sector, with allocations from only the most sophisticated investors. Leveraged buyouts were just beginning to attract attention, and venture capital investing was concentrated in Boston and the emerging Silicon Valley in California. Total PE assets under management (AUM) in 1990 were $21.3 billion, or just $0.2% of the $9 trillion in global public equity markets at the time.

By 2020, PE had expanded beyond the United States to become a global industry, with $2.3 trillion in AUM, and was a significant component of the asset allocation of many investment programs. Public equity still had much higher market capitalization ($109 trillion) than private equity. But the number of US companies listed on public stock exchanges had dropped by about half from its peak of 8,000 in the 1990s, while the number of PE-owned companies quadrupled to nearly 9,000.

This dramatic growth has garnered criticism over PE's high fees, questionable performance reporting, and concerns about liquidity and risk. So it is important to understand the reasons behind the rise of private-market investing and why it is likely to keep growing.

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Internal rate of return (IRR)

IRR is the interest rate at which the net present value of all cash flows (positive or negative) from a project equals zero. The calculation assumes that all cash flows are reinvested and earn the same until maturity. IRR is frequently used as a measure of performance in PE and venture capital.

> "The contrasting advantages of private ownership have been starkly revealed recently: being privately owned, with the support of sophisticated PE sponsors, allowed many companies to weather the stresses of the GFC and the COVID-19 shock better than companies whose stock market valuations were plummeting."
>
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Growth and Evolution of Private Markets: The Key Drivers

Several factors have converged to create an environment that allows private markets to flourish.

Regulatory Changes: Over the past 40 years, regulation of publicly traded companies has become much stricter. This has given the owners and managers of private companies an incentive to keep them private rather than going public.

Evolution of Credit Markets: The global financial crisis of 2008 led to a wave of new regulations designed to restrain banks from engaging in risky lending practices. At the same time, private companies increasingly have been able to obtain credit in private transactions from nonbank lenders (e.g., direct lenders and private credit). As a result, the international banking system has ceded business to private debt funds and crowdfunding—as well as platform-based lending and finance disintermediation technologies that themselves are backed by PE.

Broader Acceptance of Private Markets by Institutional Investors: Over the past 30 years, institutional investors have upgraded their capabilities in investment management, strategic asset allocation, research, and risk management. This has led them to allocate significant assets to PE. According to a 2021 study, pension funds allocate an average of 7% to 8% to PE; endowments, foundations, and sovereign wealth funds allocate 13% to 16%; and family offices allocate 24%.

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High Performance: A key driver of the broad acceptance of PE is the higher long-term performance it has provided compared to publicly traded assets. Based on the widely used PE performance measure of internal rate of return (IRR), the Cambridge Associates index shows that the median US PE fund outperformed the S&P 500 Index by an annualized 1.4% between 2011 and 2021 (and by more over longer periods). There is legitimate criticism of IRR as a performance measure, especially in light of PE's higher fees and artificially smoothed performance relative to public markets. Nevertheless, even other performance measures, such as the public market equivalent (PME) approach, show a strong correlation between higher allocations to PE and higher total rates of return.

Growth and Innovation: There are far fewer public companies than privately held ones, and they are experiencing increasing pressure to deliver short-term returns, at the possible expense of long-term growth and innovation. Meanwhile, long-term investors have come to realize they may miss out on important investment opportunities if they do not allocate some assets to PE. It therefore is likely that private companies will be among the fastest-growing in the industries of tomorrow.

Diversification and Return Smoothing: The performance of PE has shown low correlation with that of public markets, and PE's realized returns have been less volatile than those of public markets. PE's smoother returns are due in part to the fact that the prices of publicly traded assets fluctuate every day, while PE assets are priced only once a quarter or less. This has been called "artificial smoothing." But artificial or not, PE's smoother returns and low correlation with public markets have attracted funds from investors looking to diversify their portfolios.

Better Alignment for Long-Term Investors: Investors can trade in and out of public assets every day, but investors in PE must lock up their investments for extended periods. In the past, this acted as a deterrent to PE investing. But with the growth of indexing, high-frequency trading, and activist hedge funds, any disappointing quarterly report can trigger an exodus of investors and assets, a drop in stock prices, and demands for changes in management. As a result, public market investors are more focused on short-term performance. In private markets, however, short-term pressures are lessened because PE sponsors work with company management to develop multiyear plans that build value and provide funds to weather short-term challenges. PE is therefore better aligned with the objectives of long-term investors such as pension funds and endowments.

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Private Markets Are Becoming More Liquid, and Public Markets, Less Liquid: Innovations in private markets have shortened the time in which investors must keep their funds locked up in PE assets. A key driver has been the growth of secondary-market transactions. For example, a PE general partner may put mature PE assets into a new fund where existing investors can choose to sell or hold them. Meanwhile, post-GFC regulations incentivized broker–dealers to reduce their inventories of securities, which can lead to less market liquidity, particularly during stressed periods. So public markets have become less liquid—making relative illiquidity less of a reason to avoid PE.

Looking to the Future

Institutional investors likely will allocate even more assets to private markets in the future for two major reasons.

Closing the Return Gap: The current global market environment, with richly valued public stocks and low bond yields, makes it increasingly difficult for institutional investors to meet long-term total-return targets. A classic 60% stock/40% bond portfolio has an expected future return of 3% to 5%, while pension fund contributions and funding ratios are calculated based on a target return of 6% to 8%. Closing this "return gap" is very important for institutional investors with long-term future obligations. Reaching target returns of 6% to 8% with a traditional stock/bond portfolio may have been realistic in the past, but the consensus is that future returns will not match the growth of past markets (see Exhibit 1).

Exhibit 1: Historical Returns vs. Projected Future Returns

Key Asset Classes	Historical Returns (Dec. 2011–Dec. 2021)	Projected Future Returns (20 Years)
US Treasuries	2.2%	1.2%
US Corporate Bonds (A and above)	4.4%	2.0%
US Corporate Bonds (BBB)	5.3%	2.4%
US High-Yield Bonds	6.8%	2.9%
US Stocks	16.6%	7.0%
Private Equity	20.9%	10.8%
Real Estate	7.8%	6.6%
Hedge Funds	6.5%	4.4%

Sources: Neuberger Berman, Bloomberg-Barclays, Cambridge Associates, and FactSet.

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Because PE is expected to produce the highest returns among key asset classes, investors who need to close the return gap and diversify their portfolio likely will allocate some funds to PE.

Evolving Treatment of Private Markets in Asset Allocation Frameworks: Institutional investors are moving away from categorizing PE and private credit as “alternative” investments. Instead, they are creating new groupings of investments based on their key drivers of investment returns. They are grouping PE with public equity, private credit with public credit, and private real estate with public real estate. This blurring of public/private market distinctions also will likely help drive even more asset allocation to private markets over time.

> “As private markets have come to represent a greater proportion of economic activity, investors have recognized that they could miss an array of increasingly important return opportunities if they do not invest in them. In fact, I would argue that PE is rapidly becoming an essential exposure to capture the true long-term equity risk premium.”
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Conclusion

Private-market investing is becoming increasingly mainstream. In the past, multiasset portfolio managers built portfolios almost entirely of stocks, bonds, and perhaps commodities and hedged strategies. But clients now want to include private markets in their portfolios, in order to increase returns, expand their investment playing field, and allocate assets across the broadest possible opportunity set. With continuing innovation and the potential for disruption of financial markets (e.g., through new technologies such as blockchain), the mainstreaming and expansion of private markets likely will continue.

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