Private assets bring a number of potential advantages to potential portfolios, from return enhancement to reduced risk. However, increased demand means that the low hanging fruit have now largely gone. Highly attractive opportunities remain, but buyers need to be more discriminating in their sector and manager selection.

A burgeoning market
Private assets have been popular with endowments and official institutions (such as sovereign wealth funds and government pension plans) for some time. However, more recently, they have also been attracting increasing interest from other institutional investors. Private debt in particular has come of age in the years after the financial crisis. Our 2018 Institutional Investor Survey found that average private asset allocations are expected to increase above 13% in 2018, with growth across all major investor types and regions.

In this paper we address two of the most common reservations we hear about private assets:
1. Why lock your money up for years (and sometimes decades) when there are plenty of other assets which don’t constrain you in this way?
2. Am I too late to invest in private assets? Earlier investors may have done very well but are valuations now too high?

We cover the main categories of private assets, as set out in Figure 1, below. Risk, return and liquidity profiles vary significantly. Some offer the prospect of higher returns, others greater certainty of returns. A simplified summary of some of the main characteristics is shown in Figure 2 on the next page, with publicly-traded equities, corporate bonds and high-yield debt included for comparison.

1. Schroders Institutional Investor Survey, 2018

Illiquidity
A key feature of private assets is their illiquidity – this is a core reason why they can offer the prospect of higher returns – but even here there is great variety. Money can be locked away for as little as a few years to as long as several decades on some infrastructure projects. Furthermore, while an investment vehicle could have a long life, this can be broken down into a number of different phases. It will include a period during which capital is committed to it but not yet drawn down (when it can be invested elsewhere but may be called on at short notice), a period when capital is drawn down and invested, and then a divestment period, when assets are sold or debt matures and the proceeds are distributed to investors. The result is that capital is not tied up for the entire life of the vehicle. For example, while private equity buyout funds typically have a life of 10 to 12 years, individual tranches of capital will generally only be drawn down for an average of four to seven years at a time. It is this second period when the investment is truly illiquid.

Figure 1: Private assets – the main categories

![Figure 1: Private assets – the main categories](Image)
### Figure 2: A bird’s eye view of the private asset landscape

<table>
<thead>
<tr>
<th>Category</th>
<th>Holding period of underlying investments (years)</th>
<th>GBP yield (%)</th>
<th>Credit spread (%)</th>
<th>Extent of investor control</th>
<th>Alpha potential</th>
<th>High potential returns</th>
<th>Stable income generating</th>
<th>Security</th>
<th>Low risk of capital loss (single investment)</th>
<th>Low risk of capital loss (portfolio)</th>
<th>Equity diversifier</th>
<th>Government bond diversifier</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Equity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PE: large buyout</td>
<td>4-7</td>
<td>2-3</td>
<td>n/a</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>X</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>PE: small/mid buyout</td>
<td>4-7</td>
<td>n/a</td>
<td>n/a</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>XX</td>
<td>XX</td>
<td>X</td>
<td>X</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>PE: venture capital</td>
<td>5-8</td>
<td>n/a</td>
<td>n/a</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
<td>X</td>
<td>✓</td>
</tr>
<tr>
<td>Infra equity</td>
<td>10+</td>
<td>5</td>
<td>n/a</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Real estate</td>
<td>4-6</td>
<td>4-5</td>
<td>n/a</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>IG corporate bonds</td>
<td>Daily liquidity</td>
<td>2-3</td>
<td>1.0-1.5</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
<td>✓</td>
<td>X</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Senior infra debt</td>
<td>10+</td>
<td>3.5-4.5</td>
<td>1.75-2.25</td>
<td>✓</td>
<td>X</td>
<td>XX</td>
<td>✓</td>
<td>X</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Senior real estate debt</td>
<td>5-7</td>
<td>2.5-3.5</td>
<td>1.0^-2.5</td>
<td>✓</td>
<td>X</td>
<td>XX</td>
<td>✓</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>High yield debt</td>
<td>Daily liquidity</td>
<td>4-5</td>
<td>3-4</td>
<td>XX</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>X</td>
<td>XX</td>
<td>X</td>
<td>X</td>
<td>✓</td>
</tr>
<tr>
<td>Junior infra debt</td>
<td>5</td>
<td>5-6</td>
<td>4-5</td>
<td>X</td>
<td>X</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>X</td>
<td>X</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Mid-market direct lending</td>
<td>3</td>
<td>5-7</td>
<td>4-6</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>SME lending</td>
<td>5</td>
<td>8-11</td>
<td>7-10</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>

Reporting dates vary. Analysis based on the most up to date data obtainable as at June 2018.

Infra = infrastructure, IG = investment grade, SME = small and medium-sized enterprise

Although they do not normally have a formal credit rating, senior infrastructure debt and senior real estate debt share characteristics with investment grade corporate bonds, in terms of credit quality. Similarly, junior infrastructure debt, mid-market lending and SME lending share characteristics with high yield (sub-investment grade) debt.

*Currency exposure assumed to be unhedged for equity investments and hedged for debt investments. GBP shown for illustrative purposes only to permit comparison across assets. Equity yields unchanged in other currencies. Hedged debt yields vary according to interest rate differentials. For example, as at 31 July 2018, USD-hedged yields would be approximately 1.6% higher than those shown, EUR-hedged yields 1.2% lower and JPY-hedged yields 0.9% lower.

**Lower end of range is for Germany.

***Typically floating rate debt, paying a coupon which increases with interest rates

Categories above are not exhaustive and are shown for illustrative purposes only.

Sources: Bank of America Merrill Lynch, Callan Associates, CBRE, De Montfort University, Ernst & Young, International Property Forum, NEOS, Preqin, Schroders and Thomson Reuters Datastream.
Real estate's experience is more mixed as listed real estate investment trusts (REITs) have actually outperformed private core real estate funds over the long run, although this can be explained by the higher leverage in REITs (which also makes them more volatile).

A large part of the return pick-up in private assets arises because their illiquidity means they are less attractive to many investors. This can result in an illiquidity premium, a reduction in the price or additional yield to compensate for having money tied up.

In reality, the magnitude of the additional return offered by private assets is not due solely to illiquidity but also to other factors like transaction size, complexity and the deal sourcing ability of an investment manager.

Another advantage is that investment managers in private markets have more levers at their disposal to improve returns (Figure 6). They are much more hands-on than their public equivalents and have access to a wider range of information in a timelier manner than is possible in public markets. Private equity general partners routinely influence corporate strategy and appoint directors and management. Real estate managers actively manage lease extensions and building refurbishments. Private debt managers negotiate covenants which give them greater protection than would be standard in corporate bonds. In some cases, these give them the right to step in and direct strategy if a borrower is struggling.

The private debt return advantage over public markets
As well as a higher credit spread or yield, private debt comes with the added attraction that it is normally exposed to a lower risk of loss than equivalent-rated corporate bonds. This has one of two drivers (or both in some cases):

1. Lower average default rates
2. Higher average recovery rates

Infrastructure debt scores highly on both metrics. The projects themselves are less susceptible to default risk than the broader corporate sector and the debt is secured on an underlying physical asset, such as an airport or toll road. This boosts recovery rates in the event of a default - the most common recovery rate has been 100%, meaning most investors have incurred no losses at all, even when there has been a default.

1. Why private assets?
There are four ways in which private assets can potentially add value:

1.1 Provide higher returns
1.2 Give access to a broader range of exposures, industries or outcomes
1.3 Reduce risk (volatility and/or risk of loss)
1.4 Add diversification benefits

1.1 Higher returns
An attraction of private assets is their ability to earn a higher return than public equivalents. As shown in Figure 3, private equity has handsomely outperformed public equity over time. The same is also true of private infrastructure equity, which has outperformed public infrastructure equity by 1.3% a year over the past decade. Attention often focuses on the higher fees charged by private asset investment managers, but these results are net of all fees. In the fixed income world, private debt commands a credit spread premium over public markets without the need to take on additional credit risk, as highlighted in Figure 2. In today's world of low return expectations, this return premium has taken on added importance.

### Figure 3: Private assets have typically outperformed, net of fees

![Graph showing private assets outperforming public assets over time](image)

Past performance is not a guide to future performance and may not be repeated

For illustrative purposes only. US large cap is S&P 500 index; US small cap is Russell 2000 index; private equity is PrEQIn index; All figures are total returns and private equity returns are net of fees. Sources: FTSE Russell, Preqin, Standard & Poors and Thomson Reuters Datastream.

### Figure 4: Sources of added value

<table>
<thead>
<tr>
<th>Factor</th>
<th>Source of add value</th>
<th>Public market</th>
<th>Private market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market timing</td>
<td>Deciding appropriate entry/exit point</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Stock selection</td>
<td>Identifying most attractive opportunities</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Negotiations</td>
<td>Ability to negotiate attractive entry price/conditions</td>
<td>X</td>
<td>✓</td>
</tr>
<tr>
<td>Operational improvement</td>
<td>“Hands-on” approach with ability to effect change</td>
<td>~</td>
<td>✓</td>
</tr>
<tr>
<td>Leverage</td>
<td>Ability to boost equity returns and instil financial discipline at portfolio companies</td>
<td>~*</td>
<td>✓</td>
</tr>
</tbody>
</table>

* The ability of public market investors to influence a company's capital structure is more limited than in private equity. The efforts of activist investor are the main exception. Individual investors can borrow to invest in the stock market, but the additional risks associated with this strategy, including the need to make margin payments, mean that this is relatively uncommon.

Source: Schroders
The secured nature of real estate debt also provides protection from losses, especially now that financing structures are more conservative than in the past. Average loan-to-value ratios on European commercial real estate are now around 50%, meaning a 50% decline in value would now be required before senior debt holders would be exposed to the risk of loss.

Lending to small and mid-market companies is generally “sub-investment grade” (sometimes referred to as high yield) risk but the universe is highly diverse and can be on an unsecured basis. However, even here, recovery rates of 40-50% are higher than on normal corporate bonds.

A combination of higher credit spreads and lower expected credit losses combine to great effect for private debt. (Figure 5, right hand chart).

1.2 Access to a broader range of exposures, industries or outcomes

For certain assets, the public market captures only a small subset of the overall market. This is a particular issue in European debt markets, where only around 20% of corporate financing has historically been provided by capital markets, with the vast majority of the rest being provided by the banks. With the post-crisis retrenchment of the banking sector in Europe, there is now an attractive opportunity for institutional investors to step in and fill the void left behind by the banks. This opportunity is only accessible in private markets.

The narrower focus of the public market can also result in sector or regional allocations that misrepresent the broader asset class. The public infrastructure debt market, for example, is 90% utilities and 60% US dollar debt, a poor reflection of the more globally and sectorally diversified infrastructure industry.

Public equity and bond markets also tend to be open only to larger issuers, given the costs of acquiring and maintaining public status.

A further issue is that, for a variety of reasons, companies are increasingly turning their back on public equity markets and preferring to stay private for longer, if not indefinitely. Investors focused solely on public markets risk missing out.

1.3 Lower risk

Private assets exhibit lower volatility than public markets. However, measuring and understanding risk in private assets is challenging.

While there can be fundamental reasons why certain private assets could be considered lower risk than their public peers, this is also partly down to the fact that valuations are only updated infrequently, if at all, and are not always tested against public market prices (“marked to market”). Both features dampen volatility. In the main version of this paper we discuss some of the possible approaches to tackling this issue and this is a subject we intend to return to in future work.

Putting aside measurement issues, there are a number of fundamental drivers of private asset volatility that can be qualitatively appreciated:

- Infrastructure’s reduced sensitivity to the economic cycle and the contractual nature of real estate leases provide more stable underpinnings to returns than in public equities.
- For a given asset, a more leveraged investment is riskier than a less leveraged one. This would suggest that large buyouts are riskier than public equities...but small and mid cap buyouts are less highly leveraged and some other strategies employ little or no leverage at all.

2 What is the point of the equity market?, Schroders, April 2018.

Figure 5: A win-win for private credit from higher credit spreads and lower loss rates

Higher credit spreads (%) – Lower credit loss rates (%) = Higher net credit spreads (%)

Note: IG and HY corporate bond credit loss rates incorporate default losses (default rates adjusted for recovery rates) and price changes arising from changes in credit quality (net downgrade losses). Investors in private debt will not generally experience downgrade losses (or upgrade gains) as the credit spread component typically remains unchanged unless there is an impairment (high risk of default). Consequently, private debt loss rates above only reflect default losses. Figures are shown for illustrative purposes only and may not be reflective of credit spreads or default experience on any individual investment or portfolio. Source: Bank of America Merrill Lynch, Callan Associates, CBRE, De Montfort University, NEOS, Preqin and Schroders
Enhanced access to timely information and the ability to do much deeper due diligence helps to mitigate the risk of any individual investment.

Some of the volatility in public markets is driven by fear and greed rather than underlying fundamentals. Private asset investors are typically unable to sell their stakes in such an environment, preventing them from making the same behavioural mistakes.

Notwithstanding the desire to fit private assets into a traditional risk/return framework which allows easy comparison with other asset classes, a bigger question is whether volatility is really the right measure for investors in private assets to be looking at? It measures how bumpy the ride is, but that is somewhat meaningless for a private asset investor who has committed themselves to locking their money up for a period of several years. Risk of capital loss is a more worthy focus and this can be shown to be more favourable in many private assets compared with their public equivalents. The full version of this paper includes more detail on this topic.

1.4 Diversification benefits

Given their differing underlying exposures and return drivers, private assets offer diversification benefits compared to public markets. These vary by asset class and market.

Analysis of correlations runs into difficulties given the challenges in assessing valuations. A better approach is to look through to the underlying exposures. For example, economically sensitive assets are likely to have similar underlying return drivers to equity markets whereas the return profile for others can be quite different. Figure 7 provides indicative guidance about the relative strength of relationship that various private assets have with returns from public equity and government bond markets.

Figure 6: Private assets have different underlying risks to public markets

<table>
<thead>
<tr>
<th>Cashflow stability</th>
<th>Asset-backing/security</th>
<th>Investor protections / covenants</th>
<th>Superior access to information for active manager</th>
<th>Long term nature shields from short term noise</th>
</tr>
</thead>
<tbody>
<tr>
<td>Illiquidity</td>
<td>Leverage</td>
<td>More limited valuation transparency for end investor</td>
<td>Concentrated individual funds</td>
<td>Elevated performance dispersion between funds</td>
</tr>
</tbody>
</table>

Source: Schroders

Figure 7: Sensitivity to public equity and bond markets varies by sector

Illustrative relationships

![Diagram showing sensitivity to public equity and bond markets by sector](image)

Source: Schroders

* typically floating rate debt, paying a coupon which adjusts to moves in interest rates
Note: gov = government, corp = corporate, infra = infrastructure, opp. = opportunistic, RE = real estate, SME = small and medium-sized enterprises
2. Am I too late?
Demand for private assets has accelerated in recent years. An unfortunate consequence is that there has been too much money looking for a home. “Dry powder”, money that has been raised but not yet drawn down, is at record levels. Increased competition for assets has pushed prices up. However, this pressure has not been universal. For example, our proprietary Schroder Adveq Fund Raising Indicator (Schroder Adveq FRI), developed to assist investors in assessing the private equity landscape, highlights a divided market. It suggests that investors would be wise to prioritise exits in the large buyout, late-stage venture/growth and Chinese renminbi markets. For new investments, more favourable conditions exist in small/ mid buyouts, early stage venture capital and in certain emerging markets. Similar differentiation can be seen in real estate and infrastructure equity markets.

On the debt side, the market for long-dated senior infrastructure debt is highly competitive but the junior market is far less so. The larger end of the private corporate debt market has also become very crowded, with record volumes of capital raised. However, the smaller end of the market remains less well served.

In general terms, the low hanging fruit have now largely gone. High valuations increase the risk of overpaying. The illiquidity of private assets makes this a bigger problem by fuelling regret risk. However, as illustrated in the examples above and in Figures 2 and 5, many parts of the private universe continue to offer good value. At this stage of the cycle, investors need to be more discerning about where and with whom they invest their money.

3. Practical considerations
A notable feature of private assets is the wider dispersion of returns than in public markets. The difference in return between top and bottom quartile US private equity managers has been around 15%, on average. Manager selection is therefore more important than ever.

Investing in private assets also introduces some fresh challenges. The cashflow profile of an investor’s liabilities – such as the need to make payments to members of a pension scheme for instance – has implications for the amount they can afford to invest in illiquid assets. However, in our experience, most investors have greater capacity to invest in illiquid assets than they realise. In addition, private debt, infrastructure and real estate equity are all highly cash generative and can be used to help meet cashflow liabilities.

A second element of liquidity management is the practical issue of managing withdrawals of capital and further investments to ensure exposure to an asset class is built up and maintained, if desired. Decisions must be made about how committed capital is invested to ensure it is available when called upon, without detracting from an investor’s overall objectives. A detailed discussion of these topics is outside the scope of this paper but they should be carefully considered before an investment in private assets is undertaken.

Conclusion
Private markets offer a rich variety of investment options. They provide a return uplift over public markets and, in some cases, a reduction in risk. Prices have risen but attractive opportunities remain. In the more competitive markets, access to deals has grown in importance as a source of alpha. At this stage in the cycle investors need to be more discriminating in where they invest and who they appoint to manage their money.
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