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In focus

Can you successfully combine private and public in multi-asset?

We delve into whether the benefits of combining public and private assets into a single multi-asset portfolio outweigh the risks

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The arguments for expanding an investment portfolio into private assets are well known. It can improve diversification. It can allow access to potentially high returning opportunities. It can even offer an additional skill or 'complexity premium' from the most skilled managers (particularly for those with a superior deal sourcing network).

Combining public and private assets into a single external multi-asset portfolio is gathering momentum amongst institutional investors, particularly for those who haven't invested in private assets yet. Even so, the liquidity challenges of private assets are still there. Here, we lay out the benefits of combined public-private portfolios, and weigh them against the risks.

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Rising, accelerating interest

Quantifying asset flows into blended public-private investment mandates is difficult. There is, however, clear evidence to demonstrate rising interest among institutions and insurance companies.

Our 2021 Global Institutional Investor Study[1], incorporating the views of 750 institutional respondents, confirmed this growing appetite with 47% of investors looking to diversify into alternatives and private markets, up from just 26% in 2020. Furthermore, 42% of investors are increasing their use of private assets to 'manage risk within the portfolio', with asset class diversification the single most important strategy for risk management.

The largest institutions continue to want to add to their private assets, as has been a trend for over a decade. However, some that haven't done it yet are looking to offer single mandates to skilled managers who can manage both public and private in one portfolio.

What are the advantages of combining public and private assets into one portfolio?

In our experience there are four key reasons for asking a portfolio manager to manage a combined portfolio across multiple asset classes:

1 Single point of governance;
2 Improved management of committed cash and disbursements;
3 Management of the public portion of the portfolio while cognisant of the private portion; and
4 Consistent measurement of overall portfolio risk, sustainability profile and impact.

1. Single point of governance

For institutional investors that haven't yet dipped their toe into private investments, a public-private portfolio could be an easier first step than investing in a separate private portfolio.

In the past, governance in the broadest sense has been a deterrent for potential investors. A large, well-resourced investment management team, with a hybrid skill-set in both private and public assets and a rigorous due diligence approach, is needed for public-private portfolio management.

It is significantly more difficult to analyse private asset managers when compared to active managers of public funds. The range of outcomes is wide and market indices are not typically representative of how a given individual investor might perform. In recent years there has been a proliferation of products – across strategy and geography – with the number of active private-capital firms surpassing that of hedge funds. Handing over the burden of asset selection and due diligence is an appeal in itself for those looking to combine public and private assets into a single multi-asset portfolio.

The governance benefits continue beyond the initial due diligence and portfolio construction stages. Monitoring underlying exposures, while managing cashflows at the total portfolio level, are equally significant and we come onto these next.

[1]Schroders Global Institutional Investor Study 2021. The respondents represents a spectrum of institutions, including corporate and public pension plans, insurance companies, official institutions, private banks, endowments and foundations, collectively responsible for $26.8tn in assets. Research carried out during February and March 2021.

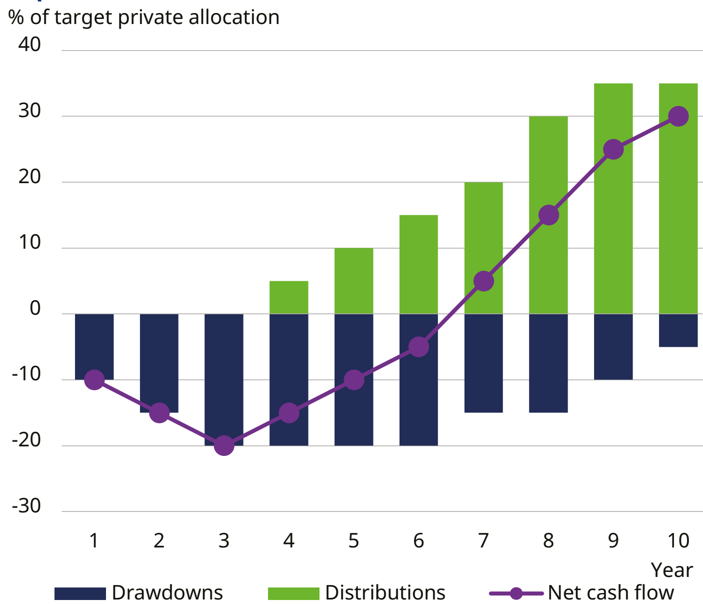
2. Improved management of cashflows

After committing to a private asset investment, it can take some time until the cash is drawn down and actually invested. In a multi-asset public-private portfolio, the committed cash can be invested in the public portion both to improve returns and facilitate an easier transfer when the cash is called to be invested in the private portion (see Figure 1).

Some private investments also throw off cash fairly frequently in small amounts such as infrastructure debt and private credit. Real estate debt strategies, as another example, typically look to generate stable, contractual cash flows through the payment of regular coupons. Rather than the asset owner having to deal with these disbursements, they can be efficiently handed from the private portion to the public portion by the overall manager.

The ability for one manager to co-ordinate cashflows helps to streamline portfolio rebalancing and accelerates the process of re-investing into the preferred areas of the portfolio. Additionally, for asset owners who are looking to improve the overall sustainability/impact of their portfolio, the cashflows can be invested in liquid assets in line with these objectives.

Figure 1: an integrated approach is needed to manage funding requirements and distributions



Source: Schroders. For illustrative purposes only. Projected net cash flow profile for a model multi-asset public-private portfolio over ten years.

3. Managing the public portion with an eye on the private portion

In order to ensure the overall portfolio is well balanced, there are a number of factors to consider when constructing a public portfolio around a private portfolio. These include – sector or geographical exposure, risk premia/asset class, liquidity profile, correlation and sustainability budget[2].

Monitoring exposures to certain sectors, industries or market environments is more effective when the total portfolio is managed under one roof. Figure 2 demonstrates the typical factor exposures of assets across the liquidity spectrum.

Figure 2a: factor risks need to be monitored effectively at the total portfolio level – Illiquid and semi-liquid assets

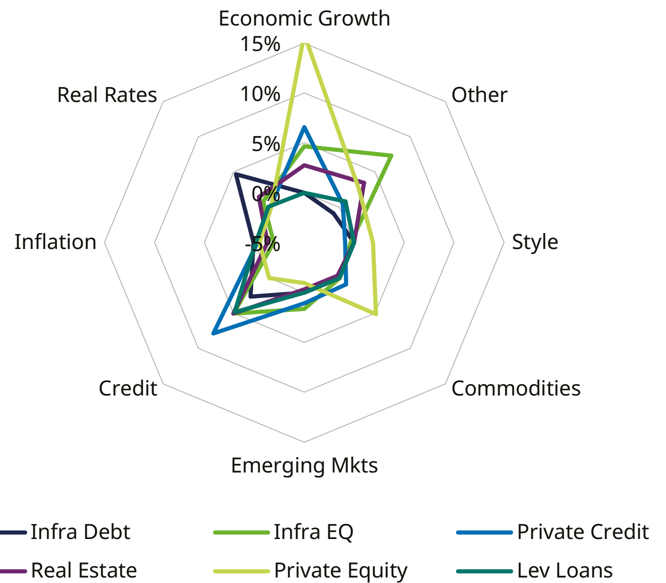
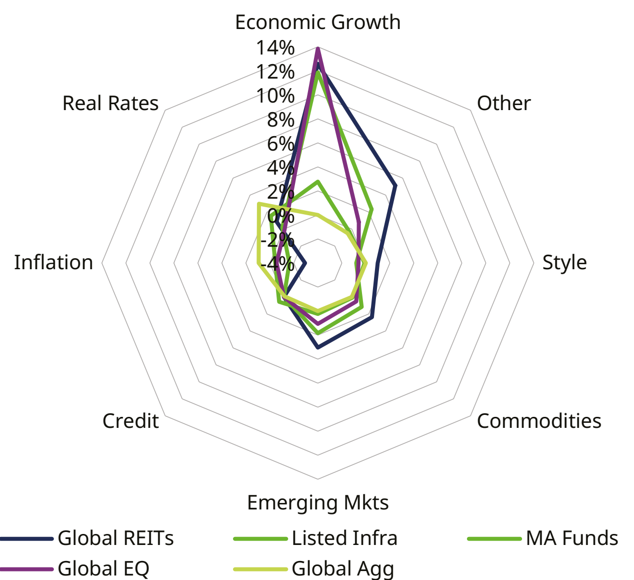


Figure 2b: Liquid assets



Source: Schroders, Blackrock – Aladdin Factor Workbench. Factor risk calculation as of end of August 2020, based on monthly 15yr lookback window.

2 https://www.schroders.com/en/uk/pensions/insights/thought-leadership/introducing-the-sustainability-budget/

Having an integrated approach to sustainability is also now key for many institutional investors. Sustainable practices have been sweeping private markets, as they have public markets. Some institutional investors have pre-determined targets around carbon, UN Sustainable Development Goals (SDGs), or have sector-specific exclusions across their whole public-private portfolio. A multi-asset public-private portfolio can be constructed holistically across public and private assets to provide access to certain themes, social impact or SDGs. The infrastructure sector, for example, offers a gateway into the renewable energy industry and the overarching decarbonisation theme.

In relation to liquidity, a multi-asset public-private portfolio could allow the manager to reduce the exposure to less liquid assets in the public portion if liquidity in a crisis was a concern to an asset owner. This could be achieved by reducing the portion held in credit, real estate and infrastructure for example.

Inevitably however, this will result in lower diversification in the public portion (and possibly lower returns in this portion too) as a consequence of improving the liquidity. As ever with investing, there are trade-offs to be considered by asset owners in discussing a suitable approach with their portfolio managers.

4. Consistent measurement across public and private portions

There is no 'one size fits all' approach for measuring and reporting on public-private multi-asset portfolios. Risk and return measures, combined with sustainability metrics, will be bespoke to each individual asset owner. The time horizon of the investor will also influence the frequency of reporting.

Data quality and accessibility will play a key part in transparent reporting. Ultimately, the closer the investor to the underlying assets, the better the availability of data. Consequently, the investment team is better placed to build tailored reports at the total portfolio level. Clearly, there is a mismatch between the way in which private asset returns are typically assessed (using IRRs) and public equity (total returns). If the multi-asset public-private portfolio consists of larger proportions of public assets, total return is likely to be the focus of reporting. If private is the larger proportion, IRRs would be used.

There are distinct differences between the characteristics of private assets and publicly-listed securities, primarily with valuation metrics and liquidity. This makes performance more difficult to measure on the private side. Unlisted assets are not marked-to-market, meaning that asset valuations have a time lag. With few benchmark options for private market investments, institutional investors may look to use multiple market indicators. Access to a range of benchmarks is needed to build bespoke reports.

The quality of sustainability and impact reporting at the total portfolio level will differentiate asset managers. Being able to source, analyse and report on ESG (specifically climate) and SDG metrics is a challenge for public-private mandates. While access to third-party data will play a role, investment teams must be consistent and co-ordinated in their approach.

What are the challenges of combining public and private assets into one portfolio?

Some may think that by putting public and private assets together in one portfolio, it miraculously improves the liquidity of holding private assets. But this is not a magic wand – the liquidity of the private portion of the portfolio is the same whether it is combined with other assets or not. Being mindful of funding requirements that arise from capital calls is important at the portfolio construction stages, and the level of liquidity will impact overall asset allocation. Net capital calls are likely to be high, especially during the first five years.

When crisis conditions occur, some investors need to redeem assets to meet their cashflow requirements. Asset owners may look to their public-private portfolio to provide the liquidity. However, this just results in the public portion of the portfolio being depleted because the private portion's liquidity characteristics are unchanged. A public-private portfolio can provide liquidity flexibility in most conditions but when everyone is running for the exit, liquidity is challenged.

This can have additional issues. By depleting the public portion and any available liquidity, a skilled active manager can't take advantage of the buying opportunities that happen in a crisis, resulting in an opportunity cost to the overall portfolio.

It is possible to use private equity funds which are semi-liquid to improve day to day liquidity management. These typically have monthly subscriptions and limit quarterly redemptions to a proportion of the value of the fund. Similarly, liquidity issues can be substantially mitigated when a closed-end structure like an investment trust is in operation.

Are public-private portfolios suitable for all institutional investors?

On balance some institutional investors – those with large allocations to lower-risk assets in their multi-asset public portfolios – are less likely to benefit from a public-private portfolio. Those institutional investors that have the ability to use a wider range of assets/higher allocations to growth assets may find them more beneficial. This is because the former are more likely to have a lower tolerance for illiquidity risk in general.

Conclusion

We believe the benefits of including private assets in a multi-asset portfolio include potentially greater returns and further diversification. In addition, there are clear benefits for institutional investors who want to reduce their governance burden of having separate public and private portfolios. Consistent reporting is likely to be less of a headache for the asset owner, while cashflows can be more efficiently managed. And the overall portfolio can be better aligned to the overarching risk, return and impact objectives of the asset owner. We do, however, remain acutely aware of the of liquidity risk and need to manage the portfolio accordingly to avoid stress during difficult market environments.

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