Investing in private markets in 2022

An introduction

11 March 2022
Chief Investment Office GWM
Investment research

UBS

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Private markets
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Editor-in-chief
Mark Boehme

Editor
Aidan Fenten

Authors
Karim Cherif
Kiran Ganesh
Christopher Swann

Contributors
Jason Draho
Michael Gourd
Antonia Sariyska
Dan Scansaroli
Lorena Scheusan

Project management
Corinne Fedier
Joël Savioz

Design
John Choi
Werner Kuonen
Alessia Marsella
Helena Powers

Cover picture
Getty Images

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Executive summary

We think it has become increasingly important for investors to consider exposure to private markets. In our view, private markets offer a combination of high potential returns, a long-term focus, and access to innovative and fast-growing businesses.

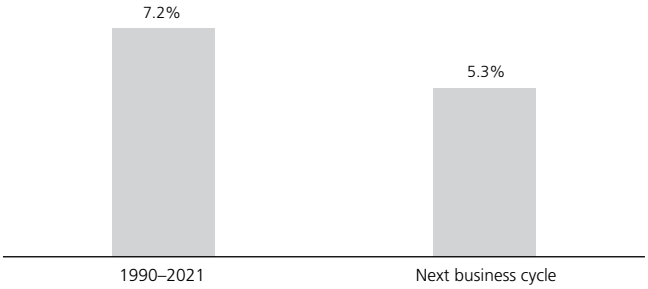
Private equity investing can provide more differentiated return drivers than listed investments if managers are able to add value through active ownership and operational value creation. For investors able to commit capital for longer—and with a plan for managing risks arising from lower liquidity—we think these advantages can make private market investments a crucial part of most portfolios.

Return expectations across asset classes have fallen in recent years. As a result, constructing portfolios with high expected returns has become increasingly challenging. According to UBS CIO's long-term capital market assumptions, a portfolio consisting of 60% global equities and 40% global fixed income is expected to return just over 5% over one business cycle, as compared to 7.2% historically (1990–2021). While we see average annual returns on US equities moderating to around 6%, we expect returns from private equity to average around 9%. Higher private market returns have the potential to help ensure investors meet their financial goals.

While the preference for liquidity among many investors is understandable, it may come at the cost of lower long-term returns.

Figure 1

Historic vs. expected returns of a 60/40 global equity bond portfolio



Source: Bloomberg, UBS Capital Market assumptions 2022
Indices used: Bloomberg Global Aggregate, MSCI World

In addition, with careful planning, the downsides to illiquidity can be managed, for example by identifying an investor's liquidity needs over the short, medium and long term then constructing a portfolio that meets these requirements. Illiquidity also has certain benefits, including preventing investors from selling out during market dislocations, while allowing managers to take advantage of attractive valuations during such periods. Private markets may also suit investors looking to participate in long-term secular trends in the economy or match long-term liabilities.

While private markets face some of the same current headwinds as public markets, including elevated inflation and rising interest rates and heightened geopolitical risks, we don't see this as a reason for delaying investment. Skilled managers are well-placed to adapt to these challenges. In addition, we don't favor efforts to time private market investment given the long lead times for deploying capital and longer holding periods.

Our preferred approach to investing in private markets, as in public ones, is to diversify. Investors should allocate to various private equity funds across geographies, managers, strategies, and vintage years (starting year of the fund). Strategy diversification reduces dependence on any single factor or strategy exposure. Geographic diversification reduces dependence on a single economy or region. Manager diversification reduces the risk of over-exposure to the biases of any single fund manager. Vintage year diversification ensures investors are exposed to the opportunity set and market conditions across time, to mitigate performance variance between funds launched in different years.

For investors focused on both sustainability and financial returns, private markets investments offer an opportunity to deploy capital toward incremental, measurable impact that goes beyond what is generally achievable in public markets.

Currently we favor exposure to managers who are disciplined with capital deployment and are able to source investment opportunities in companies that can withstand inflationary and interest rate pressures. From a thematic perspective, we favor digitization, healthcare, energy transition, and Asia as a region. Finally we see direct lending, core real estate and core infrastructure as useful strategies to generate yield while mitigating inflation and interest rate pressures.

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Why the world's biggest investors use private markets

Private markets have grown in popularity among institutional investors: average allocations for US public pension plans rose from 18% in 2012 to 20% in 2020, according to Public Plans Database. A key reason for this increase is the view that the asset class can improve both absolute and risk-adjusted returns for investors relative to traditional liquid portfolios and offer differentiated investment opportunities.

Historically, private markets have outperformed public markets by a significant margin. For many investors, this additional return premium can enable greater wealth accumulation and wealth transfer opportunities or support ongoing expenses. Illiquidity, value creation, and financial engineering are some of the drivers to this outperformance which we expect to persist in the coming years.

Private markets are also becoming an increasingly important asset class because of their access to opportunities not available through listed markets.

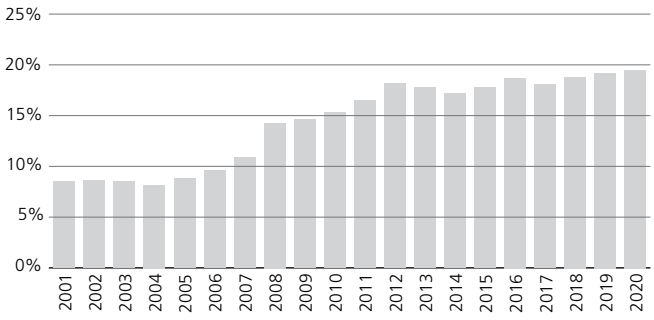
The supply of listed companies in developed markets is shrinking. More companies are choosing to stay private, delaying listings or avoiding them altogether, with contributing factors including high listing costs and regulatory burdens. The average number of initial public offerings per year in the US fell from around 300–400 between 1990-2000 to around 130 in 2001-2021. An abundance of private capital has also provided entrepreneurs with an alternative to the traditional listed market route. According to Pitchbook data, the number of private equity backed companies globally increased by an annualized rate of 10.7% since 2000.

For investors, this means gaining exposure to fast-growing and innovative businesses is becoming harder when only investing in listed equities. Importantly, upon listing, these companies are often larger and at a more advanced stage of their lifecycle. As a result, they may not offer the same growth profile and return opportunity. Therefore many investors are complementing public equity exposure with private equity investments as a way to access a wider spectrum of equity opportunities, add differentiated sources of returns to portfolios and potentially avoid missing out on returns.

Private markets remain a fraction of the size of traditional markets. Private equity net asset value for instance, only represents roughly 5% of public market value. But assets are rising fast driven by performance and fresh investor flows. Across all investor segments, allocation intentions point to accelerated growth. According to Preqin, private capital could grow by 14.8% per annum between 2021 and 2026 to reach USD 17.8tr from USD 8.9tr at the end of 2021.

Figure 2

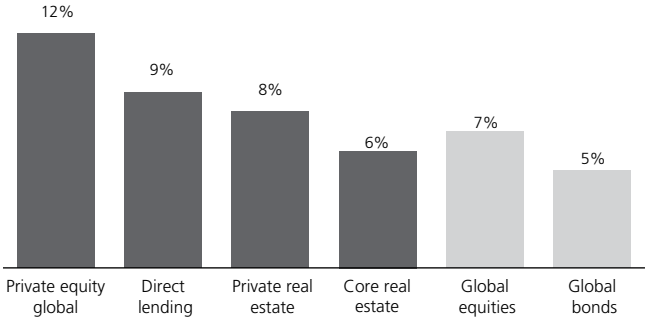
US public pension allocation to private markets



Source: Public Plans Database 2021

Figure 3

Historical returns for various asset classes



Source: CAPE Global Private Equity Index, Cliffwater Direct Lending Index, Cambridge Real Estate Index, Global Real Estate Fund Index, MSCI AC World, Barclays Global Aggregate. Data covers period January 01 2001 and December 31 2020. For CDLI and GREFI Jan 2004-2020

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How private investors should think about private markets in their portfolio

The UBS Wealth Way framework is designed to help investors achieve their lifetime goals as well as preserve and grow their wealth over generations. The approach can help investors create a purpose-built investment portfolio that is implemented across three strategies:

Liquidity strategy: The Liquidity strategy is designed to help meet short term needs, while insulating the investor from having to sell assets during periods of market volatility, locking in otherwise-temporary losses.

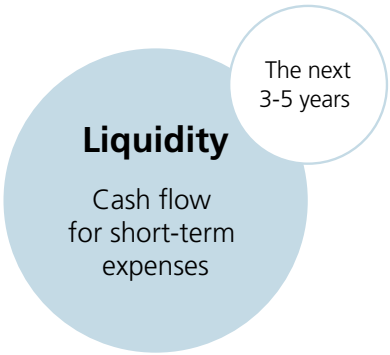
Longevity strategy: The Longevity strategy is designed to help meet lifetime goals.

Legacy strategy: The Legacy strategy represents an investor's excess resources—wealth that goes beyond what is needed to meet one generation's lifetime objectives. This strategy focuses on wealth maximization, and on effectively passing this wealth across generations and to charity.

It is the individual investor's objectives and circumstances that primarily dictate the appropriate asset allocation choices. This also applies when thinking about how much to allocate to private markets.

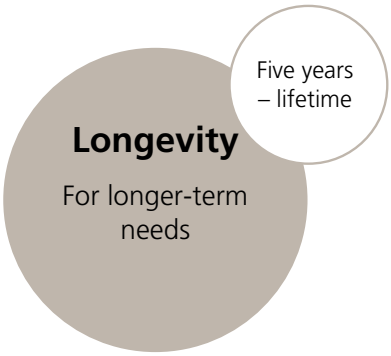
Investors are often averse to private markets given their preference for keeping liquid assets on hand. Private market funds are generally buy-and-hold investments with 10-year commitments (with two-year extensions possible). Typically, investors fulfill capital calls or investments occurring in years 1 to 5 and can start receiving back distributions in years 6 to 10. Such prolonged lockups can deter some investors, who favor more liquid assets, even though they typically may not have a purpose or timeline for using that liquidity.

However, investors may forget that liquidity comes with an opportunity cost of investing in public markets. When we look at how much to allocate to private markets through the lens of the UBS Wealth Way framework, investors may discover that



To help **maintain** your lifestyle

- Entertainment and travel
- Taxes
- Purchasing a home



To help **improve** your lifestyle

- Retirement
- Healthcare and long-term care expenses
- Purchasing a second home

To help **improve** the lives of others

- Giving to family
- Philanthropy
- Wealth transfer over generations

Source: UBS

UBS Wealth Way is an approach incorporating Liquidity. Longevity. Legacy. strategies that UBS Switzerland AG, UBS AG and UBS Financial Services Inc. and our advisors can use to assist clients in exploring and pursuing their wealth management needs and goals over different timeframes. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved. All investments involve the risk of loss, including the risk of loss of the entire investment. Timeframes may vary. Strategies are subject to individual client goals, objectives and suitability.

they can tolerate higher proportions of private market assets as a percentage of their overall wealth than if they chose an asset allocation that is less cognizant of their goals, time horizon and liquidity needs.

Illiquid assets such as private markets can be incorporated in both the Longevity and Legacy strategies depending on investor circumstances, while the Liquidity strategy can help manage any risks associated with illiquidity.

So, in a Longevity strategy, private markets can provide additional returns, which can help keep portfolios from being depleted by spending, allowing investors to spend more during the course of their lifetime, or even retire earlier.

A higher expected return in the Longevity strategy could also give investors the opportunity to fund lifetime expenses with slightly less capital, allowing them to set aside more excess capital for the next generation or for philanthropy in the Legacy strategy.

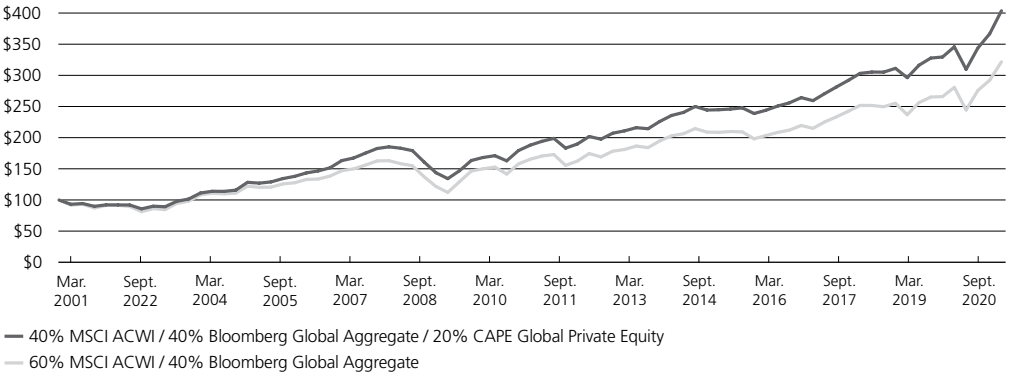
With the right plan, the illiquidity issue can be accounted for. A Longevity strategy is designed to help meet lifetime goals through both growth and income, and so we expect it to be gradually depleted throughout retirement. With this in mind, we generally recommend that investors approaching retirement consider transitioning the Longevity strategy toward a more liquid investment portfolio. This can include a mix shift within their private market portfolios toward semi-liquid fund structures or managers focused on core private real estate, private credit, and secondary market strategies. These strategies can provide regular distributions, shorter J-curves (the pattern of cash outflows and inflows associated with private market investing), or lower risk versus traditional private equity mandates.

But the bulk of these investments may reside in the Legacy strategy, where illiquidity is less of a risk. Legacy strategy portfolios incorporate many of the same attributes of endowment funds, including perpetual time horizon, high tolerance for drawdowns, and the goal of preserving inflation-adjusted value of assets. This combination means that investors can consider higher allocations to private market and real assets in a Legacy strategy. Impact investing in particular is well-suited to address wealth preservation across generations alongside positive outcomes for people and planet as part of the investor's Legacy. Such impact would occur in addition to what an investor does as part of their philanthropic activities, since impact investing is part of investment portfolios and targets market-rate returns. Liquidity concerns, however, should still be considered, especially for investors who may wish to give away part of their wealth during their lifetime, where the next beneficial owner has a preference for liquidity.

Figure 4

Adding private equity to portfolios: Historical analysis

A 20 year look back, adding a 20% allocation to private equity from public equity in a 60/40 portfolio



Source: Bloomberg, UBS, 8 March 2022

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How to think about private markets in the current environment

We don't encourage timing private markets given the long lead times for deploying capital and longer holding periods. However, we do believe that periods of volatility offer opportunities. And it can be useful to switch focus from short-term concerns to long-term opportunities. Historically, investors who have continued to invest through prior volatile periods have been rewarded with higher long-term returns.

At present, several risks are front of mind for investors, in particular elevated inflation, rising rates and Russia's invasion of Ukraine.

Based on recent private market performance, our view is that skilled managers are taking these risks into account in their deal underwriting and portfolio construction process with the objective of creating value through the full economic cycle.

On inflation, for instance, managers are positioning portfolios for resilience, focusing on investing in quality companies that are better positioned to weather a high price environment.

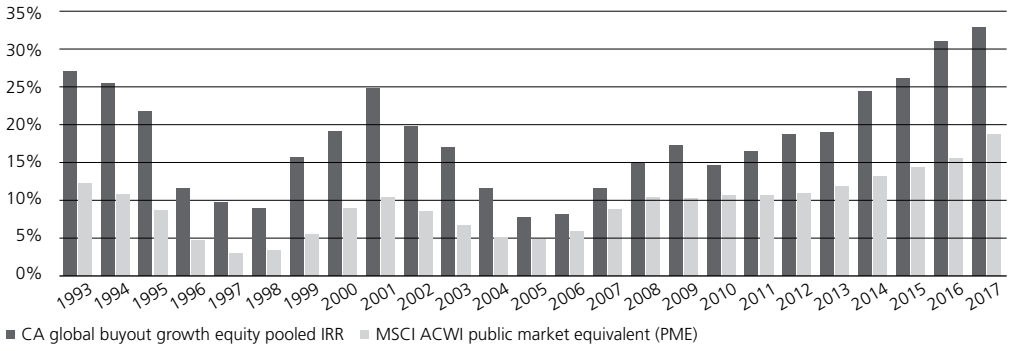
By this we mean companies that are market leaders are typically price setters as opposed to price takers. This demonstrates they can efficiently manage their operations, balance sheets, working capital and defend their cash flows without destroying demand. From a sector perspective, we expect more selectivity in industrial and manufacturing businesses which could suffer more from higher inflation. Other sectors notably healthcare and technology should be more insulated. Managers have already been adjusting their strategies to adapt to higher interest rates and their impact on valuations. They have done so by becoming more disciplined with capital deployment, using more conservative multiple expansion assumptions and focusing more on value creation to drive returns. The private market industry has evolved from its early days, when financial engineering was a key driver of returns. Today managers are less focused on financial engineering and more on value creation. Leverage applied is more conservative and US buyout equity contributions, for example, are close to 50% currently. Private equity managers have used debt financing given the low interest rate environment in the past years. But, with interest rates likely to rise, they may favor lower leverage ratios for new deals and/or consider hedging the cost of debt for existing deals for instance by swapping floating rates for fixed rates.

Importantly, not all assets or companies are treated equally in the face of rising inflation and interest rates. Real assets and direct lending strategies for instance have implicit or explicit protective features against rising rates and inflation.

A key risk to our view is if commodity prices and inflation expectations begin to rise significantly, forcing central banks to act more aggressively and thereby negatively impacting growth and corporate earnings. Such a scenario would be consistent with a prolonged war in Ukraine and/or widespread disruption to commodity supplies. Should this materialize, we expect existing portfolio companies to suffer, depending on their activity or geography and potentially be held longer. Managers, as in previous crises, would look to step in and help prevent any financial or operational stress. This scenario, however, would likely also offer opportunities to deploy capital in new deals at more attractive valuations. Historically, crisis vintages have rewarded investors with above average returns.

Figure 5

Vintage year IRR comparison between global PE and public equities



Source: Cambridge Associates, UBS, as of 3Q21
The public market equivalent (PME) calculation is a private-to-public comparison that seeks to replicate private investment performance under public market conditions.
Note: Given most funds take a few years for performance to settle, performance of recent vintage years may be less meaningful.

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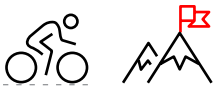
Our favorite themes in private markets for investors in 2022 – Net zero, Asia, Tech, Healthcare, Yield



This year, selectivity and building resilience will be important. However, investors shouldn't steer away from powerful secular trends. In our view, several areas of the private market space look appealing over the coming years.

First, we still think that the technology ecosystem is a compelling area of investment. Tech is permeating all sectors of the economy, and digitalization trends are likely to accelerate. Higher inflation may well force companies to adopt more technological solutions to manage their human capital and input costs to drive efficiency. Within the space we particularly like tech enablers, digitization, automation, SAAS and cybersecurity companies as well as, more broadly, B2B focused firms.

Second, we see upside for Asian private equity investments. China's latest five-year plan makes clear its goal of reducing dependence on foreign technology. The nation's R&D spending is growing twice as fast as the US, and the private sector contributes significantly to this effort. While there could be near-term volatility, we think the long-term opportunity remains intact. The Japanese local buyout market has also been exceptionally active in recent years, fueled by structural drivers such as large industrial conglomerate carve-outs and business succession-related deals. South Korea and India, two large fast-growing economies, also offer opportunities in private equity, particularly in financial services, telecom computer software, healthcare and e-commerce.

Climate and energy transition-related investments are another area where we see opportunity for investors to generate returns and contribute to mitigate the negative impacts of climate change. Transition to a low-carbon economy and attaining net zero carbon targets will require significant involvement from the private sector.

Since 2020, private equity firms have deployed over USD 60bn in climate tech and clean tech energy. Private equity managers can take a leading role in financing innovation and also leverage their operational skill set and value creation approach to help businesses transition into a fundamentally different and greener economy. In our view, the transition represents a significant opportunity for all investors, not only for those who explicitly focus on sustainability. Energy independence will likely be a dominating theme in the years ahead and we expect clean energy expansion to be fast tracked.

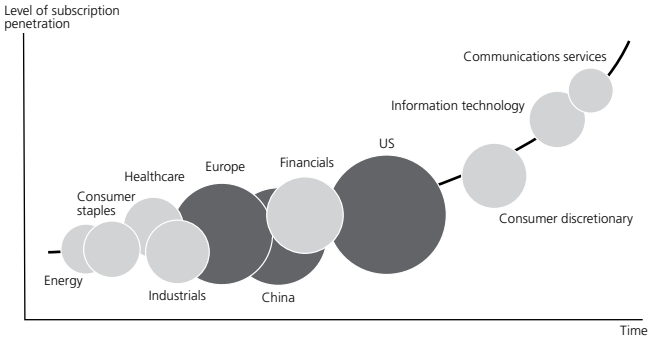
Demand for healthcare assets also remains robust. Aging populations, rising healthcare expenses and a still fragmented and inefficient industry should continue to force digitization and innovation in the field of prevention, diagnostics, monitoring, data recording as well as transformative treatments. Post pandemic, mental health has also become a new area of focus. This area of investments can also lend itself to sustainable and impact investing strategies alongside more conventional private equity investments.

And lastly, investors looking for yield should consider direct lending and core real asset strategies to improve income opportunities in excess of what is offered in the public market. Market fundamentals are supportive, and the pricing environment is balanced. Weakening protection for lenders remains a risk that investors should seek to mitigate through strict manager selection.

Figure 6

Digital subscription penetration curve

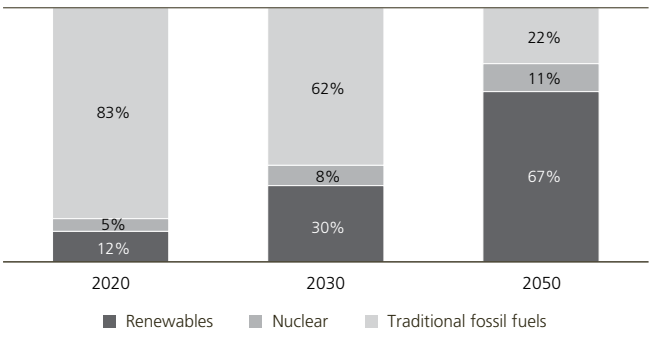
Relative subscription penetration in different segments, size of bubble indicates relative revenue size



Source: UBS

Figure 7

Projections of energy supply in Net Zero 2050



Source: Net Zero by 2050, a road map for the global energy sector, IEA October 2021, UBS

Nontraditional Assets

Nontraditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments; there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

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In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

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Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.

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