Private Market Primer
Investing in an Alternative Way

Investors have been whipsawed this year with the Coronavirus resulting in a sharp “v” shaped decline in global equities and almost an equivalent “v” shaped rebound all in a matter of five short weeks. With some equity Indices at or near their record high (e.g. NASDAQ, large and small to mid-cap growth) investors are desperately searching for value in a market where valuations look stretched. Equities are not the only class that looks pricey. Within fixed income, credit was teetering on the brink of a crisis until the Federal Reserve intervened and began stockpiling everything from investment grade to high yield bonds to avoid the health crisis turning into a credit crisis. As a result, bond yields have ground to near record lows. In an environment where the publicly traded equity and bond markets have reached frothy levels, we want to reiterate our recommendation for qualified investors to have an allocation in the private markets.

In this white paper, we will educate investors about what the private markets are, explain the different types of private investments, how private markets differ from the public markets, the importance of due diligence and how investing in the private markets adds to a well-diversified asset allocation.

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Understanding the Private Markets

The private market includes a variety of alternative investments such as private equity, private credit and/or private real assets. The private markets differ as they are not listed on a publicly traded exchange. The private market has grown almost three-fold over the past decade and globally, stood at $6.5 trillion at the end of 2019.[1] **(Chart 1).** The demonstrable growth of the private markets can be attributed to many factors including the absence of regulatory burdens in the private markets, the massive liquidity that was created by nontraditional monetary policy over the past decade, the lack of daily volatility swings and the extremely profitable IPOs of companies that were backed by private equity (e.g. Facebook, Alibaba, Salesforce). In fact, the number of private companies grew ~9% per year (from 2000-2018) while the number of publicly traded companies declined by more than 2% per year **(Chart 2)** over the same period.

Chart 2

Number of Private Equity Owned Companies Overtaking Public Market

Data is as of December 2018.

Source: Neuberger Berman, Verdence Capital Advisors.

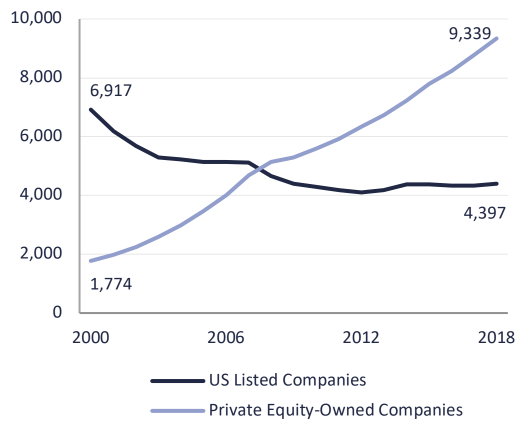

Chart 1

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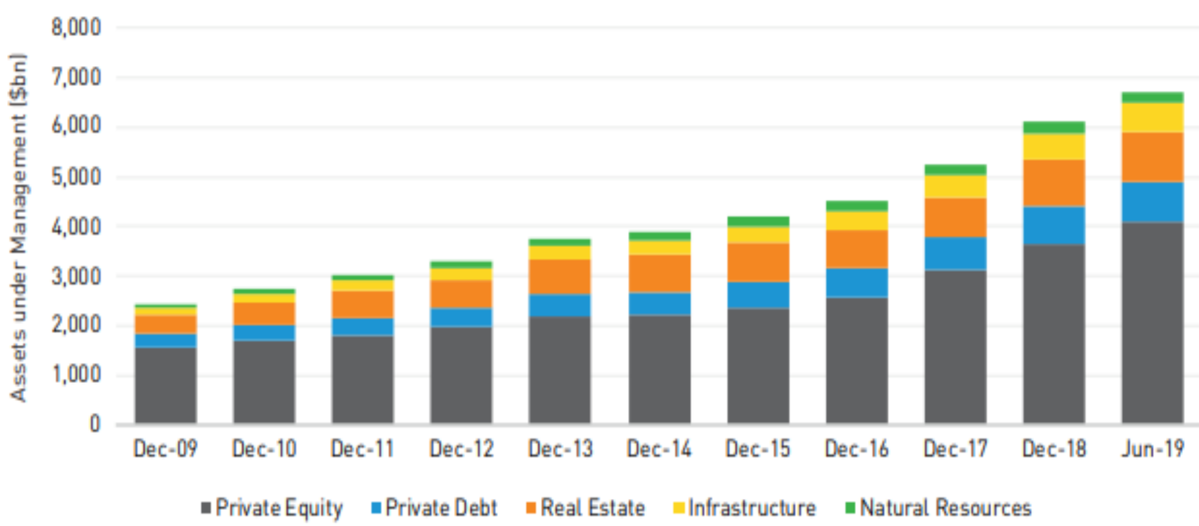

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Commonly known private market investments:

Private equity
Private credit
Real assets

Here, we outline some commonly known private market investments:

1. **Private equity –** The most commonly known portion of the private market is private equity. While select investors may invest directly into a private company, most investors gain access to private equity through a well-seasoned private equity fund and/or separately managed account. Typically, the fund is run by a general partner (GP) who gathers capital from investors and these investors become limited partners (LP). Examples of well-known private equity strategies include:

– Buyout funds typically utilize leverage to obtain enough capital to acquire a controlling stake in a company. These companies are typically mature companies and the goal is to restructure the companies to become more profitable.

– Venture capital funds invest small amounts in startup companies with the hopes of making outsized returns when the company matures. The funds typically carry more risk than other private equity funds. Most venture capital funds are either early stage where they are taking a bet on future growth (most of the time betting on an idea or intellectual property) or late stage venture capital that may have the infrastructure in place but need help maximizing their earnings stream.

– Growth funds typically invest in more mature companies than venture funds and carry less risk but a lower return profile as well. Typically, the companies they invest in are looking for expertise to make the business more profitable to potentially spin off and/or look for merger candidates.[2]

2. Private credit – Private credit funds have grown substantially over the past two decades. One of the major contributors to growth in this space is that investors are desperate for income as yields in the public bond market remain near record lows. **(Chart 3).** Private credit funds typically offer attractive yields as they lend to smaller companies that may be unable to access the public funding market at affordable rates. There are many areas within a company's credit structure that private credit funds invest in and the level of return is highly dependent on the amount of risk associated with the debt in the fund. Some common private credit funds include:

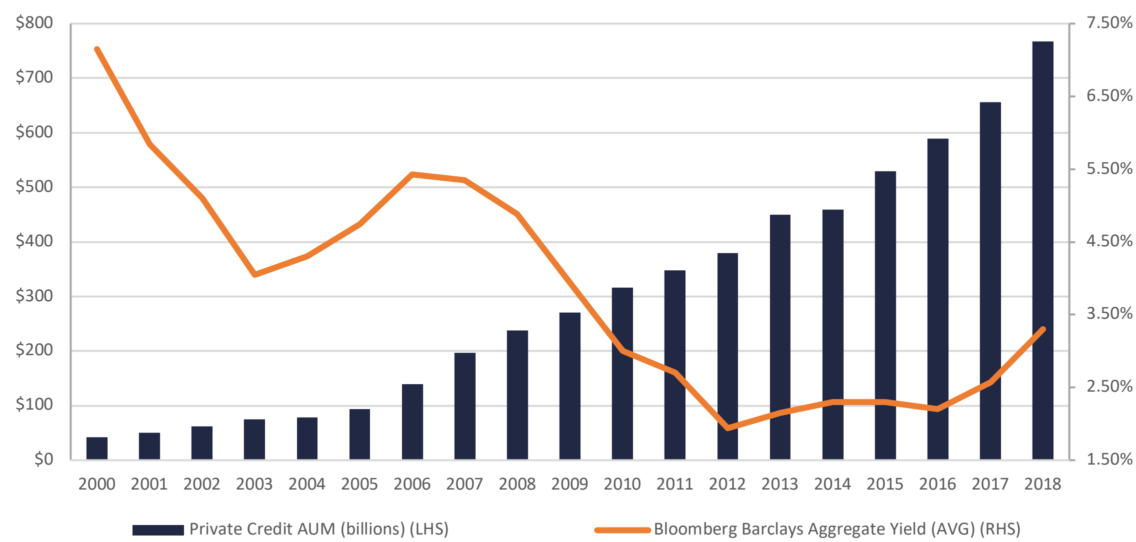
– Mezzanine and senior debt funds typically make loans to lower and middle market borrowers as either senior or subordinate loans. The structure of the loans varies as senior loans may sit higher in the payout structure in the event of default while subordinated debt sits a bit lower (but still before equity ownership).

– Distressed credit funds are funds that invest in the debt of distressed companies. They look for discrepancies between how the debt is pricing and compare it to the ultimate recovery rate in the event of default and/or the underlying value of the loans in the event of restructuring the company's debt. This type of private credit can be highly speculative and dependent on expertise in bankruptcy laws and legal corporate structures.[3] These funds carry more risk than mezzanine or senior debt funds but also can offer a better return potential.

Chart 3

Private Credit Grows as Public Bond Market Yields are Near Historic Lows

Data is as of 2018. Bloomberg Barclays Aggregate yield is the average for the year. Source: Preqin, Bloomberg Finance LP, Verdence Capital Advisors.



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Past performance is not indicative of future returns

3. Real assets – Real asset funds access a variety of investments that carry the characteristic of having a tangible value. An investment is considered to have tangible value because there is something physical that backs it up. In addition, because it has a tangible value it is also expected to keep pace with inflation and some investors utilize it for a long-term inflation hedge. Some of the common types of real asset funds include:

– Real estate funds are private funds that can invest in a pool of real estate offerings or into a direct real estate structure. Real estate funds vary across investments in office space, apartment buildings, warehouses and shopping malls. As with most private investments these represent long-term investments with capital locked up for different periods of time depending on the project. Investors are drawn to private real estate for its steady cash flow and historically negative correlation to publicly traded real estate investment trusts.

– Infrastructure funds are private funds that may participate in a public private partnership to spur infrastructure. The need for infrastructure is a global phenomenon. It is estimated that the world needs $3.6 trillion in annual spending for infrastructure. Given the limitation of government budgets to fill this void, there is always the need for public/private partnerships.[4] These types of funds may offer both capital appreciation as well as steady income.

– Natural resource funds invest in companies that focus on the extraction, drilling, production and or refining of commodities, chemicals and/or timber. Since these funds invest in the physical commodity, chemical etc. they are considered another way to hedge against inflation. These funds are long term investments and carry risk as they are heavily correlated to the economic outlook.

Get Real.
The facts about real assets

- Backed by something real, like real estate or natural resources
- Typically offers portfolio diversification
- Potential inflation hedge
- Provides income stream
- Is typically an illiquid investment

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How do the Private Markets Differ from the Public Markets?

There are advantages to investing in both the public and the private markets, especially for a well-diversified portfolio. Some differences investors should be aware of include.

1. **Barrier of entry:** With the development of mobile apps and the increasing number of online brokers, the ability to invest in publicly traded stocks is open to nearly all Americans regardless of their knowledge or individual financial situation. However, in order to access the private markets, you must be classified as an accredited investor (e.g. high net worth individual).

2. **Reduced regulatory burden:** Private companies are not constrained with regulatory hurdles and scrutiny like public companies. Regulatory filings, registrations, annual reports and highly reviewed earnings reports are some of the items that cost money for public companies but not for private companies. A public company is sold to the public, so it is forced to accept more regulations. However, a private investment is typically sold to a smaller pool of accredited investors, and not required to adhere to the same regulatory environment.

3. **Daily volatility swings absent in private markets:** Public equity markets have always been subject to daily price swings. However, in recent years these daily volatility swings have been exacerbated by algorithmic trading. Since private companies are not listed, investors do not have to see daily price swings or accept massive changes on frequent investment statements.

4. **Liquidity differences.** Investments in the public market offer daily liquidity for investors that need to sell or want to buy. However, private investors are forgoing daily liquidity and willing to lock up their money for prolonged periods of time in exchange for the potential of a better risk adjusted return.

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Due Diligence is Crucial in Private Markets

The information to value a private company is not as readily available as it is for a public company that is forced to disclose financials, so the due diligence process is more complex and even more important in the private markets than in the public markets. The efficient market hypothesis states that a publicly traded company should reflect all available public information. It should be a fair playing field for all investors because anyone can obtain the same public information. However, that is not the case in the private markets. It takes deeper due diligence and market analysis to determine the appropriate value of the private investment and the price a buyer may be willing to pay for it in the future. An example of the importance of due diligence is evident in the dispersion between returns in the public market and compare it to the private market. As can be seen in **Chart 4,** over the past 10 years those investors that invest in a publicly traded equity manager saw a very narrow dispersion in the returns (10.3% for best managers and 7.8% for worst managers). This is because all managers had the same information. However, you can see the dispersion in returns between the best managers in the private equity space (20.1%) compared to the lowest quintile managers (1.9%).

Chart 4

Due Diligence is Crucial in Private Investing

Data is trailing 10 years as of May 31, 2020. Source: Lipper, NCREIF, Cambridge Associates, HFRI, JPMorgan Asset Management, Verdence Capital Advisors.

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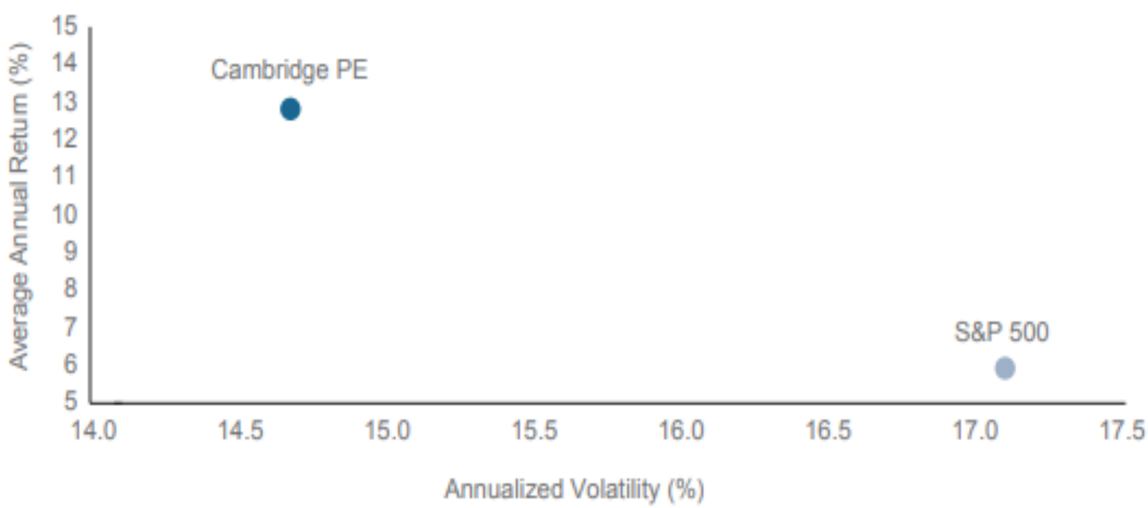
Private Investments can add to a Well Diversified Portfolio with Less Volatility

Volatility in public equity markets is typical and should be expected by investors throughout any long-term investment cycle. However, the violent daily swings that investors have had to absorb this year brought back memories of the Great Recession. In addition, a traditional portfolio of stocks and bonds has not recently been offering the same diversification benefits as it may have historically offered. This is because the Federal Reserve has been a more prominent player in the public bond markets resulting in bonds not pricing in underlying fundamentals, instead prices are manipulated by the Fed purchases. In addition, artificially low interest rates result in excess risk taking and may drive equity prices higher than fundamentals warrant. Therefore, it is important for investors to look at alternative ways to add diversification to their portfolios. The private markets not only offer the potential for attractive long-term returns and diversification benefits but also less volatility for investors to absorb. **(Chart 5).**

Chart 5

Better Returns in Private Equity with Less Risk

Data reflects trailing 20 years as of 2018. Source: Cambridge Associates, S&P Capital IQ, Verdence Capital Advisors.



Trailing 20 Year Return vs. Volatility

Cambridge PE is Private Equity Index

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The Bottom Line

Taking advantage of the private markets through a less liquid investment can provide investors with the ability to generate excess returns over time and eliminate the stress of daily price movements of a public security that may have no fundamental impact on the actual value of the business. In an environment where finding value in the public equity and bond markets is starting to entail taking on more risk, the private markets look even more attractive. In addition, the demand for good quality private investments has had investors chasing too few deals in recent years. This can be seen by private equity funds coming into 2020 with $1.5 trillion of "dry powder" or money that can be deployed.[5] However, the market conditions and dislocations over recent months have resulted in attractive opportunities for that massive amount of money to be deployed and history suggests that private investments can outperform public investments at the turn of an economic cycle. While every client's financial situation and investing goals may vary, the ability for a wide array of investors to access the private markets through different structures is growing. Therefore, we will continue to look for attractive private investments that offer our clients the opportunity for a good risk adjusted return, can enhance income opportunities and offer attractive diversification benefits.

As always, if you have any questions about our perspective, please do not hesitate to reach out to your advisor.

1. *Mckinsey Global Private Markets Review 2020 – A New Decade for Private Markets. McKinsey and Company, February 2020. Three times estimate comes from Mckinsey report and is as of 2010.*
2. *Private Equity Interviews: The Official Guide. Published by Andrew Chen.*
3. *Private Credit Strategies: An Introduction. Cambridge Associates. September 2017.*
4. *Mckinsey Global Institute, JPMorgan Asset Management, Data as of May 31, 2020.*
5. *Private equity has $1.5 trillion of unused funds and is looking to raise more. Fortune magazine. January 2020.*

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- Private investments are speculative and involve a high degree of risk. An investor could lose all or a substantial portion of his/her investment. Investors must have the financial ability, sophistication/experience, and willingness to bear the risks of an investment in a private investment.
- Private investments are not suitable for all investors. Only qualified eligible investors may invest in private investments.
- Private investment offering documents are not reviewed or approved by federal or state regulators while the offering of fund interests are not federally, or state registered.
- Private investments are not required to provide periodic pricing or valuation information to investors.
- Private investment risks may include, among other things, no or limited redemption rights; illiquid portfolios and valuation difficulties; asset, market, or industry concentration; portfolio company risks including competition and fluctuating distributions; and financing or additional funding risks.
- A private investment's fees and expenses, which may be substantial regardless of any positive return, may offset its profits.
- A private investment may be illiquid with significant restrictions on transferring interests.
- Private investments may be leveraged (including highly leveraged), which increases risk.
- Some private investments may enter into swaps, futures, forwards, options and other derivative transactions for various hedging and/or speculative purposes that can result in more volatile performance.
- Some private investments may involve structures or strategies that may cause delays in important tax information being sent to investors.

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