The Role of Private Markets in Portfolios

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by Mike Pyle
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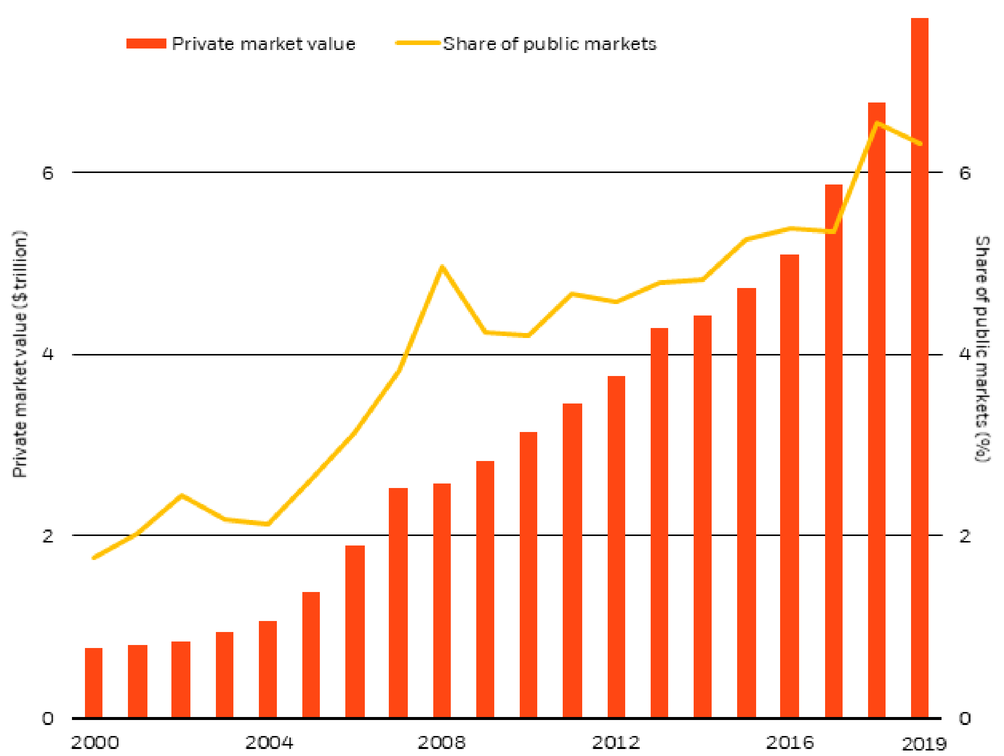
What kind of role does private markets play in building a resilient portfolio in the post-Covid world? Mike explains.

It has already been a very busy year for public markets. Risk assets sold off with the spread of the pandemic, and subsequently rebounded amid an overwhelming policy response. These actions have mostly taken place in public markets. How do we think about building resilience in portfolios now – after such drastic market action and unprecedented policy measures? We see opportunities in the slower moving, less liquid private markets, and expect them to offer exposure to structural trends that have been accelerated by the pandemic. Diversification with – and within – private markets will be crucial to building resilient portfolios, in our view.

Chart of the week

Growth in private markets, 2000 -2019



Sources: BlackRock Investment Institute, with data from Preqin, June 2020. Notes: The bars represent the sum of net asset value of closed-end funds as well as dry powder of funds in these asset classes: private equity and venture capital, real estate, private debt, infrastructure and natural resources. The line shows the size of private markets relative to that of public markets.

Private markets are bigger, deeper and a larger component of institutional portfolios than ever before. The private market universe grew to $7.7 trillion in 2019, more than triple its size in 2007, as the bars in the chart above show. The combined value of private markets now makes up about 6.3% of that of public markets, from 3.8% then (the yellow line). Allocations to private assets such as private equity (PE), private debt, real estate and infrastructure now make up around 26% of global pension fund assets, up from 19% in 2008, according to consultancy Willis Towers Watson. These markets can be illiquid and are not suitable for all investors. Yet we believe they can help investors build diversified portfolios that are more representative of the global economy than public markets alone. Our work also suggests many institutional investors are more worried than they need to be about liquidity constraints, and that owning more private assets could help them meet return and diversification goals.

Why consider private markets now? Risk assets in public markets have rapidly rebounded after hitting lows in late March as uncertainty about the virus impact peaked, removing some of the value there on a tactical basis. Even after last week's selloff, the S&P 500 index is up almost 40% from lows. The policy revolution has cushioned the pandemic's fallout, and economies are slowly reopening, making this a time to unlock value in slower-moving private markets. Moreover, we expect wide variations in activity normalization, by region and sector and company. This calls for a greater focus on *real* resilience at a granular level. We believe private markets offer this potential. Investors have a say in structuring the investments and can add custom-made resilience—via contractual provisions, avoidance of excess leverage and choice of counterparty.

Private managers at first primarily played defense in the virus shock —a rapid reassessment of the operating and liquidity needs of the assets they already owned. This is morphing into offense: seizing opportunities in the market dislocations. What is tomorrow's opportunity set? The first is providing liquidity, rescue and turnaround finance. Quality companies that have lost bank financing may need liquidity bridges while their operations recover. The shock is likely to produce a large market in distressed debt. There are at least $600 billion of distressed assets trading today, and we expect this to increase.

The second is seizing opportunities in sectors benefiting from accelerating structural trends. The pandemic is irrevocably reshaping the economy and investment landscape, and investors focused on public markets alone may miss out on opportunities in sustainability, digitalization and public health. Examples are renewable power (the most active infrastructure sector in 2019, according to IJGlobal); and technology and health care (which accounted for 19% and 13%, respectively, of private equity (PE) deals in 2019, according to Preqin).

The virus shock is unlike anything else, but the global financial crisis does hold some lessons for private market investors. First, vintages (when a private market fund deploys its capital) after a crisis tend to be good ones. Second, opportunities in different sectors come and go on different timelines—credit more quickly, for example, and real estate more slowly. Third, the difficulty of timing markets (and especially private markets) makes diversification of vintage years crucial.

Bottom line

We believe private markets will play an increasingly important role in fortifying strategic portfolios.

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Investing involves risks, including possible loss of principal.

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