Institutional Investor

What Investors Lose in an Undeveloped Secondary Market

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Performance will suffer if investors can't buy and sell stakes in private assets, researchers argue.

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(Andrew Harrer/Bloomberg)

Investors would get better returns if they could periodically rejigger their private markets portfolios based on macro factors and economic cycles, such as the recession caused by the pandemic. But unlike public market holdings, investors can't easily rebalance private investments — and their performance is suffering as a result, according to a report published Monday.

Investors can't rebalance because real estate, venture capital, and other alternative investments are made up of companies and assets that are privately held. By definition, these asset classes don't trade on an exchange where they can be bought

and sold at any time. While private assets have plenty of advantages, trading in and out of them is not one.

A paper published jointly by economic forecasting firm Oxford Economics and the Beneficient Company Group examines the rebalancing issue, with the authors arguing that it's conventional wisdom in public markets to overweight and underweight investing styles, industry sectors, and regions in a public portfolio based on expectations of the overall economic environment. Those same factors are at play and affect risks and returns of different private asset classes. As such, similar rebalancing and portfolio construction tools would improve returns and reduce risks in a portfolio consisting of private equity, real estate, venture capital, and other alternative assets.

"We suggest active tilting toward certain fund strategies, whether private equity, private debt, real estate, or infrastructure," said Yuri Mushkin, chief risk officer at Beneficient and one of the authors of the report. Beneficient provides liquidity solutions for smaller institutions and high-net-worth investors.

Mushkin explained that investors have traditionally relied on their fund managers to make asset allocation and timing decisions, rather than designing a diversified portfolio themselves. According to the report, "different private fund strategies tend to outperform in certain economic and market environments; venture capital, for instance, outperformed in the late 1990s but then struggled in the dot-com correction afterwards."

Using Oxford Economics' macroeconomic forecasts, the paper's authors argued, for example, that investors should be cautious about their current allocations to venture capital as the sector is flush with capital and competition for deals has pushed valuations to near records.

Assuming that the economy remains in a rut for the next five years — Oxford's baseline economic forecast — the researchers projected lower expected returns relative to history in private equity and private debt. They said that private debt will still be an important source of diversification, because those assets outperform similar public credit instruments. The researchers also expect natural resource and real estate funds to outperform in the next few years.

"But rebalancing isn't easy to achieve," said Mushkin. While 99 percent of public equities turn over annually, only about 1.4 percent of private assets changed hands

in the secondary market in 2019, according to the report.

According to Mushkin, it's only the largest institutional investors that use the secondary market. In the U.S., 60 percent of the market is made up of large institutions. Even those transactions take six to nine months to complete. Legal costs to draft documents and structure transactions are a large part of secondary deals, which also have to be approved by the fund's general partner.

"Look for increased pressure from institutional investors to unlock liquidity," Mushkin said.

The report pointed to 2008 and 2009, when nearly 15 percent of private investors were unable to meet capital calls from their fund managers. "The uneven market environment is likely to compound the need for liquidity in private assets, since during periods of market uncertainty investors are more likely to experience financial distress," the authors wrote.