Wealth Management

Private markets – five essential insights for charity investors

Private markets for charities

In today's rapidly evolving financial landscape, private markets are generating interest with investors, including charities. The search for higher returns, broader diversification, and access to innovative opportunities are driving this trend. As private markets grow in popularity and become more accessible, charity boards are increasingly being asked to come off-the-fence, and to take a position on whether they should be included in the charity's portfolio.

To support your decision making, we've compiled five essential insights about private markets that every charity trustee should know as they begin to engage with this asset class.

1. What are private markets?

Private markets involve investments in assets not listed on public exchanges, such as private equity, venture capital, private credit and infrastructure. As a basic principle, private markets investments are illiquid. The capital invested in private markets funds will generally be tied up for many years. Because these investments cannot be quickly bought or sold on public markets, investors demand higher returns to compensate for this inconvenience and risk. This potential for additional return is known as the "illiquidity premium".

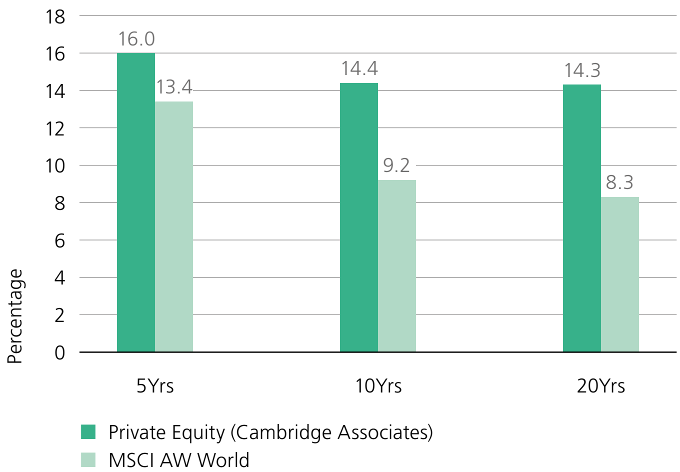
From the managers perspective, the long-term commitment of equity capital enables the company to focus on long-term value creation rather than meeting short-term market expectations. This is especially valuable when working with smaller companies and allows private market investors to buy them at attractive valuations.

With illiquidity being both the main source of private market returns and the main barrier to charities entering the asset class, trustees need to ask themselves: "What proportion of our investment assets must always be liquid, and can we afford to lock a portion of our assets away for up to 10 years in the pursuit of stronger returns"?

2. The illiquidity premium - comparing private markets to public markets

Adding an allocation of private markets to your investment strategy can strengthen your portfolio from several perspectives. The additional diversification should increase risk adjusted returns. Exposure to new sectors of the market and investment styles broadens your portfolio to a new range of return drivers. In practice, many trustees' first question is whether the returns are worth the risks (and costs) when compared to a long-term portfolio of public equities. An initial answer to this question can be found by looking at the historic returns that have been generated by the private equity asset class. Whilst past performance is never a guide

Private vs public market performance
(as of 31 December 2023 annualised)



to future returns, the outcomes for investors in private equity over the last 20 years have been consistently higher than those delivered by public markets. The 'average' private equity fund has outperformed global equity markets over a range of time horizons. To put the historical liquidity premium into perspective, over the last 20 years an investor in global public equity would now have a portfolio that was almost 5x their original investment amount. The private equity investors would have received 14x their original investment if they had achieved the average return.

Hindsight would be the most wonderful source of returns, but what about the future? Can private equity continue to generate "superior returns"? In a world of higher interest rates, the ability to enhance returns through leverage diminishes. The economics of the leveraged buy-out, where a private equity firm acquires a mature cash-generative company with debt are going to be less favourable whilst rates are high. We believe that in future returns in private markets will come more from "value creation" and that means investors need to assess their managers ability to acquire attractive companies, increase their revenues and margins and then reposition a larger, more profitable company as an attractive target for strategic buyers.

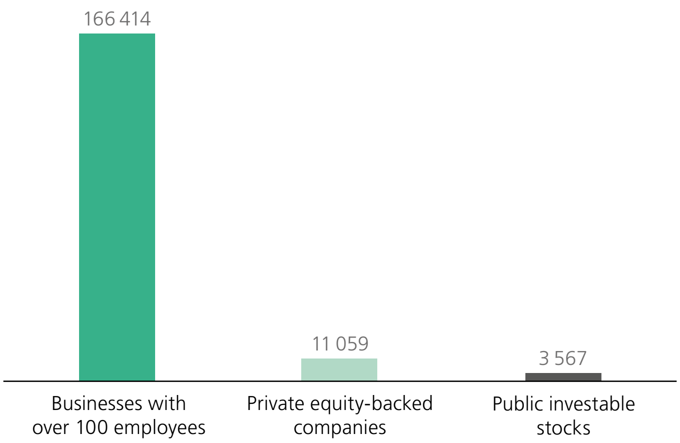
The future is unknowable, but when looking at the forecasts and Capital Market Assumptions of many large institutions their expectations for the illiquidity premium in future range between 3-5% above world equities. The takeaway is that whilst the illiquidity premium has narrowed over the last 20 years, private equity is likely to continue to meaningfully strengthen portfolio outcomes.

Broader set of opportunities and more value creation, amidst narrowing public markets

Investors should also consider how the structure of markets have changed and will continue to do so. Public market indices have been narrowing over the last 20 years due to consolidations, mergers and acquisitions. In the US, for instance, the number of listed stocks has almost halved since late 1997 and recently these indices have been concentrated in a small number of very large constituents.

It is important to recognise that most companies are private. At the end of 2023, there were over 160 000 firms in the US that employed at least 100 employees, of which only about 3 600 were listed companies. Private equity firms can tap into an opportunity set that is over 40 times larger than public markets and have significantly more room to grow. It follows that private equity investors have access to a larger opportunity set of companies, sectors and technologies than public market participants.

Private and public opportunity set in the US
(number of companies)

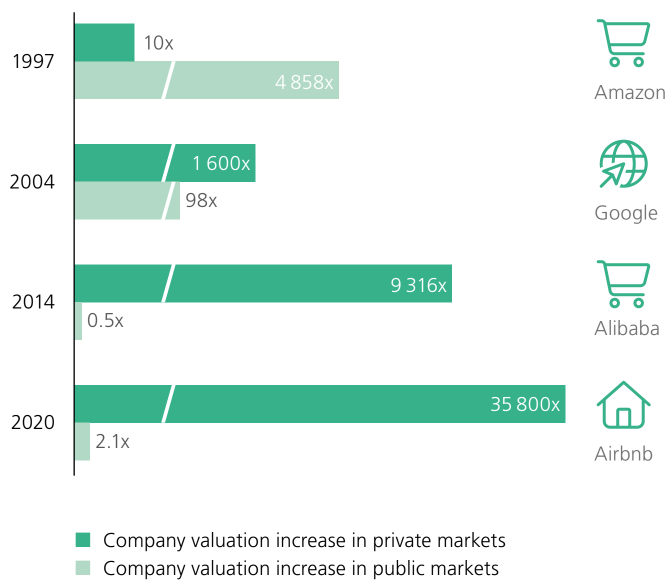


Source: LGT Capital Partners, NAICS Association, PitchBook 2023 Annual US PE Breakdown Report, MSCI USA All Cap Index. Data as of 31 December 2023.

Private equity has provided an ecosystem of capital accessible to companies at an earlier stage in their development. The result has been that many companies are choosing to stay private indefinitely, or they are listing on stock markets at a later stage of growth and development. This means more value creation is moving into private markets.

To help illustrate this trend, consider the journey to IPO of several large tech companies. In 1997 Amazon floated, after growing 10x from its first injection of private capital. Fast forward to 2020 and Airbnb grew 35 000x between its first private fundraising round and IPO.

Technology companies' valuation increase in private markets vs public markets



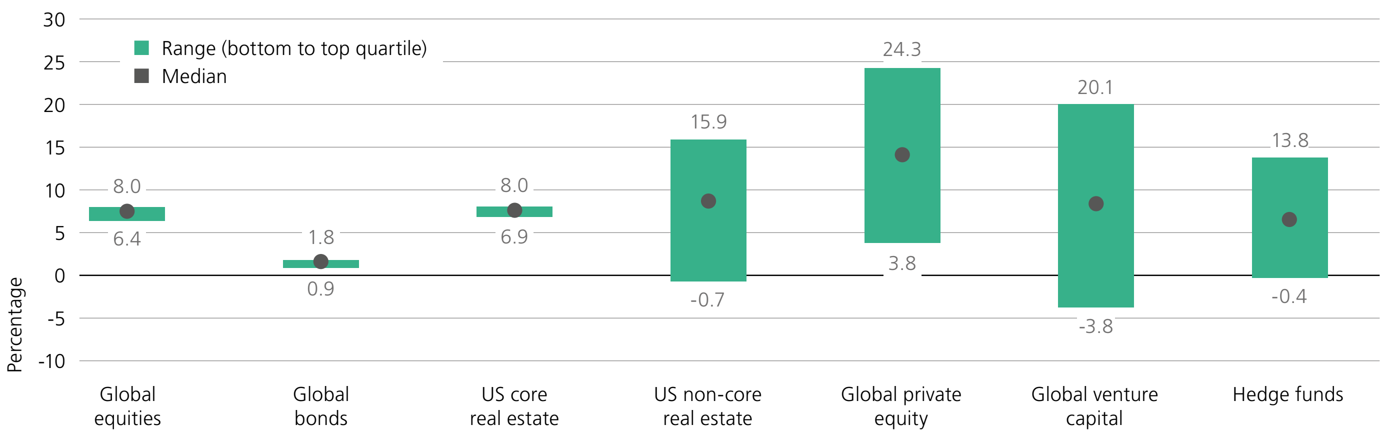
Note: Private multiple is from series A to opening price upon IPO, public multiple is the development of the Enterprise Value from IPO to 28 June 2024.
Source: LGT Capital Partners and Bloomberg.

3. The importance of manager selection – the tyranny of averages

Private companies are "hands-on" investments, where the manager has significant control and often majority ownership of the company. The range of active-management decisions available to a private equity manager, means that their level of skill is fundamentally important to the fortunes of each company they invest in and therefore the aggregate performance of their funds.

This leads to significant dispersion in the range of returns that managers deliver, especially when compared to public markets. It is important to look beyond the average return of the asset class. The chart below, shows that over the last 10 years, global private equity has delivered on average 14.4% per annum, compared with 7.2% per annum for global equities – however the range of returns between top and bottom performing managers in private markets is vast.

Dispersion of manager performance in public and private markets
(based on returns over a 10-year window)



Manager dispersion is based on annual net returns over a 10-year period ending 4Q 2023 for hedge funds and core real estate and 3Q 2023 for global equities and bond funds.
Non-core real estate, global private equity and global venture capital are represented by the 10-year horizon internal rate of return ending 3Q 2023.
Data are based on availability as of 31 December 2023.
Source: LGT Capital Partners, Morningstar, Burgiss, NCREIF, PivotalPath, J.P.Morgan Asset Management.

Identifying top-tier managers is essential for success and requires specialized skills and resources. In our experience, successful private equity managers often possess distinct skills, expertise, and industry knowledge that allow them to consistently identify and capitalize on lucrative investment opportunities. They develop repeatable investment strategies, have access to extensive resources and talent, and demonstrate adaptability and innovation.

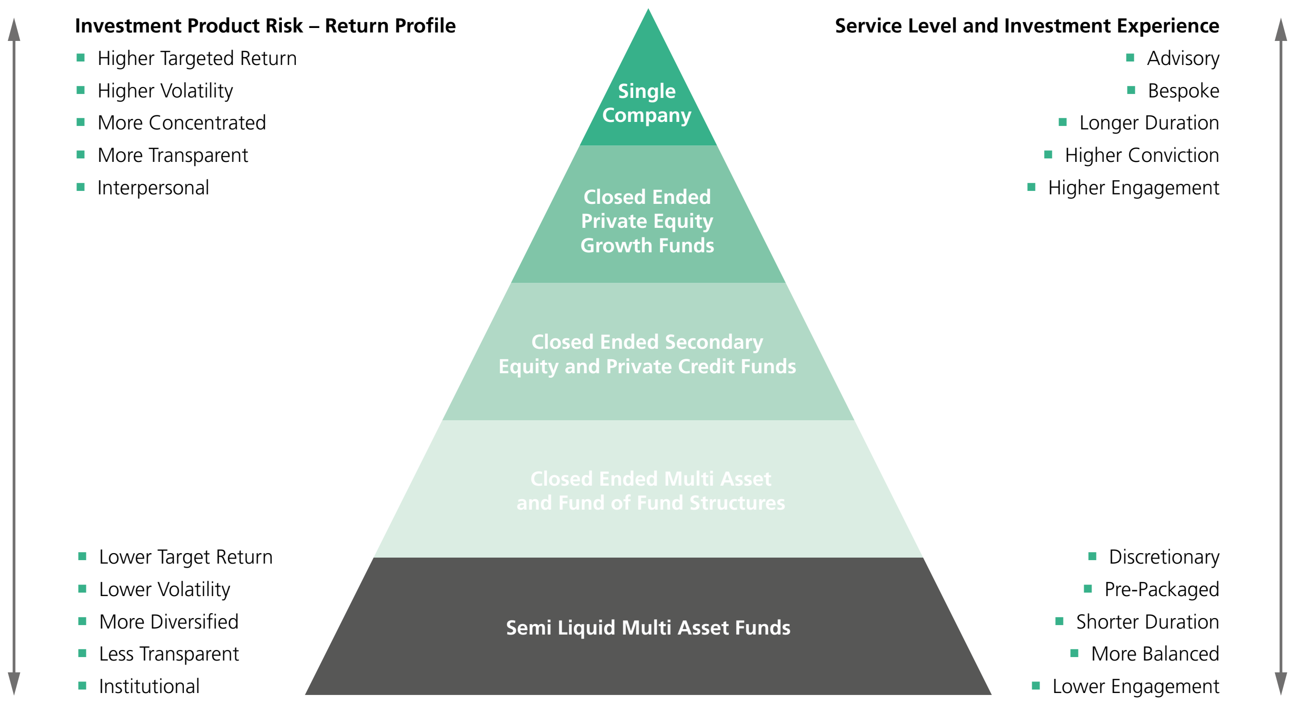
Large institutions and charities may have specialist teams to source and select managers. For many charities, they will need a specialist partner to provide the level of support they need in manager selection and support with the governance and administration of the portfolio.

4. Accessing private markets – objective setting, asset allocation, engagement and service

The basis on which a charity should access private market investments will depend on its individual objectives and circumstances. For large charities, with experienced investment committees, an approach which invests directly in single companies, or single manager closed ended funds can be highly rewarding. It requires a high degree of engagement from the charity over the life of the investments, which may include manager meetings, carrying out due diligence, constructing the portfolio and the managing capital calls and cash flows for a multi-year period. A professional partner can remove much of the administrative burden, and the investment committee can have varying levels of engagement depending on the degree of control and transparency that is required by the charity's trustees.

At the other end of the spectrum, more accessible private m arket vehicles like 'semi-liquid funds' can provide access to an existing mature and diversified portfolio of investments where investment management, administration, capital calls and cashflows are carried out within the fund. These funds can generate strong returns, but due to extensive diversification are likely to track closer to the average asset class return than top performing single manager funds.

Private markets team - product and service level options



There are many ways to access private markets and investors should be aware of the trade-offs between returns, diversification, transparency and the required engagement of the investors between the different approaches.

5. Fee structures

Private equity fee structures typically involve a combination of management fees and performance fees, which are typically higher and more complex than those associated with public market investments. Management fees are usually around 2.0% of the committed capital, charged annually to cover the operational costs of managing the fund. Additionally, private equity funds will also charge a performance fee, known as "carried interest," which is typically 20% of the profits generated by the fund, but only after a certain return threshold, or "hurdle rate," is achieved.

In contrast, public market investments, such as mutual funds or ETFs, generally have lower management fees, often below 1%, and do not usually include performance fees. This difference in fee structures reflects the more hands-on, active management and the potential for higher returns in private equity, but it also means that investors need to carefully consider these higher costs when evaluating their investment options.

In general, investors should expect a least a quarter of the gross returns generated by a Private Equity fund manager to be retained in fees and charges. Net of these fees however, we would still expect private equity funds to generate a significantly higher rate of return than quoted equities.

Conclusions

Private markets are a growing asset class, that can strengthen a long-term investment portfolio. Whilst many institutional investors have been allocating to private assets for decades, the UK Charity market has been reticent to engage with the complexity and cost of these investments.

This is beginning to change for two main reasons. The size of private markets is growing significantly and becoming harder for charity investors to ignore. Providers are coming to the market with more accessible investment vehicles and solutions that can give charity investors easier access to the asset class.

Where appropriate, charities should explore this dynamic asset class. Finding investment management partners who can provide the right level of education, experience and expertise is a sensible first step.

With over 25 years of experience investing in private assets across global markets, LGT has the capabilities and charity focus to support you in taking the next step.

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