Invesco

Private markets through an outcome-oriented lens: Growth

October 2023

Understanding the sources of return, risk, and diversification for private assets, and how it fits into a traditional portfolio is the first step toward full public and private portfolio integration. In this blog we discuss practical steps toward growth-enhancement through private markets.

Christopher Hamilton,
Head of Client Solutions,
Asia Pacific

As we continue our discussion on the effectiveness of private markets to enhance portfolio outcomes, we'll bring our focus to growth investments. It is key to define how we classify these investments, and most importantly how they can be combined to enhance risk-adjusted returns and complement traditional assets such as equities and fixed income. One common theme we see across client engagements, both in Asia and globally, is increased uncertainty about the path of economic growth given the aggressive monetary policy undertaken by Western central banks to control inflation, and subsequent downstream impact of those decisions. This is where private markets growth investments can be a useful tool to provide diversification from economic risk while still adding a meaningful long-term return premium to a portfolio.

The primary investment building block in the private market growth space is private equity, which most institutions, and a growing number of high-net worth investors, have gained considerable familiarity with over the last several years. The major categories in private equity would be buyout, venture capital, and growth capital investments, which have been mainstays since the early part of this millennium. However, as capital markets have evolved, the private growth space has expanded considerably, providing global investors with meaningful opportunities for risk-adjusted return enhancement.

As discussed in our recent piece, distressed debt is an area of strong interest, which has "equity-like" return potential with some of the unique features of debt investments such as strong capital structure positioning. Since access to these markets can be limited, this is where strong active manager capabilities can work to the benefit of investors. Another area of consideration is more opportunistic categories of real estate, such as the value add and opportunistic space. Like distressed credit, while there is an income component to asset class returns, most comes from capital appreciation. Therefore, we'll also include this in the private growth sleeve.

One key area of focus is portfolio construction within this space, and how to leverage long-term capital market assumptions and risk-modeling to design an optimal allocation which can be integrated into a portfolio of traditional assets. As with our prior pieces, we'll leverage Invesco Vision to design a portfolio schematic, test its efficacy in a broader context, and examine how it expands the overall investor opportunity set. We'll design a "private markets growth" sample portfolio utilizing asset classes discussed earlier: private equity (buyout and middle market), venture capital (early stage), growth capital investments, U.S. value add and opportunistic real estate, and distressed debt.

This document is for Professional/Qualified/Sophisticated Investors in Dubai, Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates; for Sophisticated or Professional Investors in Australia; in New Zealand for wholesale investors (as defined in the Financial Markets Conduct Act); for Professional Investors in Hong Kong; for Qualified Institutional Investors in Japan; in Taiwan for Qualified Institutions/Sophisticated Investors; in Singapore for Institutional/Accredited Investors; for Qualified Institutional Investors and/or certain specific institutional investors in Thailand; for certain specific sovereign wealth funds and/or Qualified Domestic Institutional Investors approved by local regulators only in the People's Republic of China; for certain specific institutional investors in Malaysia upon request; for certain specific institutional investors in Brunei; for Qualified Professional Investors in Korea; for certain specific institutional investors in Indonesia; for qualified buyers in Philippines for informational purposes only. It is not intended for and should not be distributed to or relied upon by the public or retail investors. Please do not redistribute this document.

Invesco

Private markets through an outcome-oriented lens: Growth

October 2023

Table 1 – Private Markets Growth portfolio

Asset	Weight (%)
Invesco U.S. Large Buyout Benchmark Proxy	27.5
Invesco U.S. Value Add Real Estate Benchmark Proxy	17.5
Invesco U.S. Distressed Debt Benchmark Proxy	15.0
Invesco U.S. Early Venture Benchmark Proxy	12.5
Invesco U.S. Growth Benchmark Proxy	10.0
Invesco U.S. Middle Market Benchmark Proxy	10.0
Invesco Real Estate U.S. Opportunistic	7.5

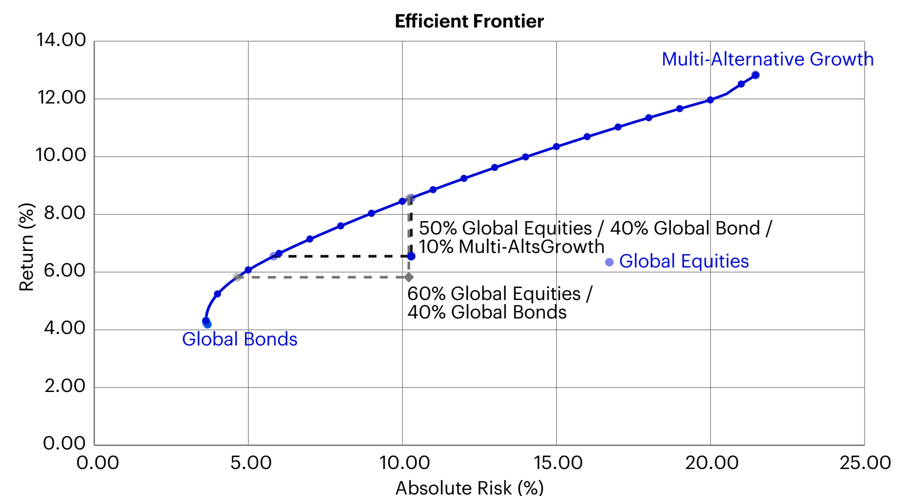
Source: Invesco, for illustrative purposes only.

One aspect that is evident is the divergence between expected return and risk among asset classes, which creates both challenges and opportunities for a portfolio constructionist. Developing asset class-level return expectations is essential to understanding the unique relationships between private markets growth asset classes. This is unique to private markets, as we've gone into detail for this series, as compared to traditional public assets. While this research is a considerable undertaking, the opportunities created through the ability to build diversified portfolios within the private markets growth space clearly outweigh the costs. There are meaningful diversification benefits to be harvested from effectively allocating to private markets. Working with partners who can help to guide investors through this process are essential.

As highlighted in prior write ups, we will leverage our long-term capital market assumptions, which span the public and private universe. Additionally, we adjust private markets by de-smoothing volatility, to provide a more "like for like" comparison across asset classes and make it more straightforward to integrate public and private asset classes together efficiently. As pointed out in our private markets income piece, and reinforced in our analysis or private growth assets, even after this volatility de-smoothing technique we still find risk-adjusted returns highly attractive.

While we wouldn't advocate for a wholesale change in the portfolio construction approach due to the illiquid nature of private markets, we want to emphasize how even a somewhat small allocation (e.g., 10%) to private markets can make a meaningful impact on risk-adjusted returns. Below we've created a sample private markets growth portfolio along with weights and expected risk and return. We will then work to integrate this combined sleeve into a portfolio of traditional equities and fixed income.

Figure 1 – Efficient frontier analysis according to private markets allocation



Source: Invesco Vision, data as of 30 June 2023. Return estimates are based on the Q1 2023 Long-Term Capital Market Assumptions. These estimates are forward-looking, are not guarantees, and they involve risks, uncertainties, and assumptions.

Invesco

Private markets through an outcome-oriented lens: Growth

October 2023

Looking at the Vision analysis, we combined the private markets growth building blocks with the aforementioned weighting schematic, titled "Private Markets Growth", in an efficient frontier universe along with the MSCI All Country World Index (MSCI ACWI) and Barclays Global Aggregate Bond Index (USD-hedged) indices. We then created a sample portfolio with a 50%/40%/10% among equities, bonds, and private markets growth, respectively. Given the relatively high volatility of private markets growth assets, we have funded that allocation solely from the traditional equity sleeve. We review the following return/risk characteristics below:

Portfolio components	Return (%)	Risk (%)
MSCI ACWI	6.3	16.7
Barclays Global Aggregate Bond Index (USD-hedged)	4.2	3.7
Private Markets Growth	12.8	21.5
50% MSCI ACWI / 40% Bloomberg Aggregate Bond Index/ 10% Private Markets growth	6.6	10.3
60% MSCI ACWI / 40% Bloomberg Aggregate Bond Index	5.8	10.3

Source: Invesco Vision, data as of 30 June 2023. These estimates are forward-looking, are not guarantees, and they involve risks, uncertainties, and assumptions.

As demonstrated above, integrating private markets growth into a traditional 60/40 portfolio provide measurable improvements, with increased return, diversification, and stable risk. Many investors associate asset classes such as private equity and venture capital as high volatility. While on a standalone basis they do maintain higher risk than traditional equities, once effectively combined with a broader private growth opportunity set, and incrementally implemented into a traditional balanced portfolio, they provide strong diversification and a long-term return premium opportunity. We also believe the portfolio should have ample liquidity given 90% exposure to public markets. We'd even argue for most investors that a higher allocation to private markets, consisting of growth, income, and real return building blocks, would still offer investor liquidity while effectively increasing strategic return opportunities. Ultimately the important piece is scaling an investor's private markets exposure around their unique constraints, as there is no "one size fits all" approach.

Summary

In sum, growth can be greatly enhanced through private markets. While conceptually this notion is straightforward, important nuances arise when forecasting long-term private markets returns, understanding risk and the way it differs from public markets and how to adjust for this, as well as the method of building portfolios both within categories such as private credit and across public and private markets. Another point that is equally as important is having the appropriate private markets opportunity sourcing ecosystem (likely through global-scale active management partners) to find superior building blocks to effectuate asset class-based views. We believe this should incorporate a diverse array of assets, and access to primary, secondary, and co-investments. To effectively execute this process in its entirety, we believe investors need to either maintain these capabilities themselves or leverage partners that can provide them by adopting an outcome-focused, client-centered approach.

Invesco

Private markets through an outcome-oriented lens: Growth

October 2023

Investment risks
The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Invesco Investment Solutions develops CMAs that provide long-term estimates for the behavior of major asset classes globally. The team is dedicated to designing outcome-oriented, multi-asset portfolios that meet the specific goals of investors. The assumptions, which are based on 5- and 10-year investment time horizons, are intended to guide these strategic asset class allocations. For each selected asset class, we develop assumptions for estimated return, estimated standard deviation of return (volatility), and estimated correlation with other asset classes. This information is not intended as a recommendation to invest in a specific asset class or strategy, or as a promise of future performance. Estimated returns are subject to uncertainty and errors and can be conditional on economic scenarios. In the event a particular scenario comes to pass, actual returns could be significantly higher or lower than these estimates.

Across a variety of alternative investment strategies, our objective is to capture the expected behavior of each strategy as represented by a broad proxy rather than a particular manager or fund. Granular data within private markets is difficult, and often impossible, to find. As such, we use objective, observable data from public proxies wherever possible as an input into our process; where data is not available, our alternatives specialists set forward-looking assumptions informed by their own experience.

Return assumptions vary by category. For Private equity, we use a building-block approach for US leveraged buyouts that captures earnings growth, valuation multiple expansion/contraction, fund leverage (and cost of financing), and fees to derive expected net returns. For other equity strategies such as venture capital, we compare historical returns to buyouts and then apply that difference to our forward-looking estimate for buyout returns on the assumption that return differences in the future will be consistent with the past.

Real Assets. For select real assets, namely Core US Real Estate and Core US Infrastructure, we utilize a building-block approach capturing rental income, maintenance CapEx, expected real income growth, expected inflation, expected valuation changes, leverage (and cost of financing), and fees to derive expected net returns. For other real assets, we utilize historical returns from NCREIF and Burgiss.

Private Credit. For most private credit proxies, we start with gross yields on underlying debt holdings and adjust for expected losses (based on historical averages), fund leverage (and cost of financing), and fees to derive expected net returns.

For a few private credit proxies, such as distressed debt, we utilize historical relationships to derive forward-looking assumptions as described above.

Approach to risk. A key principle of our risk methodology is to represent alternatives as a combination of both private and public exposures. This captures a distinct private element that is not correlated with traditional assets, while at the same time recognizing the underlying exposures themselves are often more public or traditional in nature. Taking private credit as an example, our methodology assumes exposure to a private debt factor as well as a public credit spread factor. The result is a private credit correlation with traditional assets that is greater than 0, but less than what would be suggested by public credit spread exposure alone. Because our Vision modeling platform extensively leverages the Barra framework, absolute risk for a number of alternative strategies is a byproduct of the Barra factor exposures. For alternative strategies not explicitly captured by Barra, we assume overall risk is consistent with history, with factors being mapped to the private and public factors that our alternatives specialists believe best represent the strategy.

Invesco

Private markets through an outcome-oriented lens: Growth

October 2023

Important information

This document is for Professional/Qualified/Sophisticated Investors in Dubai, Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates; for Sophisticated or Professional Investors in Australia; in New Zealand for wholesale investors (as defined in the Financial Markets Conduct Act); for Professional Investors in Hong Kong; for Qualified Institutional Investors in Japan; in Taiwan for Qualified Institutions/Sophisticated Investors; in Singapore for Institutional/Accredited Investors; for Qualified Institutional Investors and/or certain specific institutional investors in Thailand; for certain specific sovereign wealth funds and/or Qualified Domestic Institutional Investors approved by local regulators only in the People's Republic of China; for certain specific institutional investors in Malaysia upon request; for certain specific institutional investors in Brunei; for Qualified Professional Investors in Korea; for certain specific institutional investors in Indonesia; for qualified buyers in Philippines for informational purposes only. It is not intended for and should not be distributed to or relied upon by the public or retail investors. Please do not redistribute this document.

The publication is marketing material and is not intended as a recommendation to invest in any particular asset class, security, or strategy. Regulatory requirements that require impartiality of investment/ investment strategy recommendations are therefore not applicable nor are any prohibitions to trade before publication. The information provided is for illustrative purposes only, it should not be relied upon as recommendations to buy or sell securities.

By accepting this document, you consent to communicate with us in English, unless you inform us otherwise.

All articles in this publication are written, unless otherwise stated, by Invesco professionals. The opinions expressed are those of the author or Invesco, are based upon current market conditions and are subject to change without notice. This publication does not form part of any prospectus. This publication contains general information only and does not take into account individual objectives, taxation position or financial needs. Nor does this constitute a recommendation of the suitability of any investment strategy for a particular investor.

Neither Invesco Ltd. nor any of its member companies guarantee the return of capital, distribution of income or the performance of any fund or strategy. Past performance is not a guide to future returns.

This publication is not an invitation to subscribe for shares in a fund nor is it to be construed as an offer to buy or sell any financial instruments. As with all investments, there are associated inherent risks. This publication is by way of information only. This document has been prepared only for those persons to whom Invesco has provided it. It should not be relied upon by anyone else and you may only reproduce, circulate and use this document (or any part of it) with the consent of Invesco. Asset management services are provided by Invesco in accordance with appropriate local legislation and regulations.

Invesco

Private markets through an outcome-oriented lens: Growth

October 2023

Certain products mentioned are available via other affiliated entities. Not all products are available in all jurisdictions.

This publication is issued:

- in **Hong Kong** by Invesco Hong Kong Limited景順投資管理有限公司, 45/F, Jardine House, 1 Connaught Place, Central, Hong Kong. This document has not been reviewed by the Securities and Futures Commission.

- in **Singapore** by Invesco Asset Management Singapore Ltd, 9 Raffles Place, #18-01 Republic Plaza, Singapore 048619.

- in **Taiwan** by Invesco Taiwan Limited, 22F, No.1, Songzhi Road, Taipei 11047, Taiwan (0800-045-066). **Invesco Taiwan Limited is operated and managed independently.**

- in **Japan** by Invesco Asset Management (Japan) Limited, Roppongi Hills Mori Tower 14F, 6-10-1 Roppongi, Minato-ku, Tokyo 106-6114; Registration Number: The Director- General of Kanto Local Finance Bureau (Kin-sho) 306; Member of the Investment Trusts Association, Japan and the Japan Investment Advisers Association.

- in **Australia** by Invesco Australia Limited (ABN 48 001 693 232), Level 26, 333 Collins Street, Melbourne, Victoria, 3000, Australia which holds an Australian Financial Services Licence number 239916.

This document has been prepared only for those persons to whom Invesco has provided it. It should not be relied upon by anyone else. Information contained in this document may not have been prepared or tailored for an Australian audience and does not constitute an offer of a financial product in Australia. You may only reproduce, circulate and use this document (or any part of it) with the consent of Invesco.

The information in this document has been prepared without taking into account any investor's investment objectives, financial situation or particular needs. Before acting on the information the investor should consider its appropriateness having regard to their investment objectives, financial situation and needs.

You should note that this information:
- may contain references to dollar amounts which are not Australian dollars;
- may contain financial information which is not prepared in accordance with Australian law or practices;
- may not address risks associated with investment in foreign currency denominated investments; and
- does not address Australian tax issues.
- in **New Zealand** by Invesco Australia Limited (ABN 48 001 693 232), Level 26, 333 Collins Street, Melbourne, Victoria, 3000, Australia which holds an Australian Financial Services Licence number 239916.

This document is issued only to wholesale investors (as defined in the Financial Markets Conduct Act) in New Zealand to whom disclosure is not required under Part 3 of the Financial Markets Conduct Act. This document has been prepared only for those persons to whom it has been provided by Invesco.

It should not be relied upon by anyone else and must not be distributed to members of the public in New Zealand. Information contained in this document may not have been prepared or tailored for a New Zealand audience. You may only reproduce, circulate and use this document (or any part of it) with the consent of Invesco. This document does not constitute and should not be construed as an offer of, invitation or proposal to make an offer for, recommendation to apply for, an opinion or guidance on Interests to members of the public in New Zealand. Applications or any requests for information from persons who are members of the public in New Zealand will not be accepted.

- in **Dubai** by Invesco Asset Management Limited, Index Tower Level 6 - Unit 616, P.O. Box 506599, Al Mustaqbal Street, DIFC, Dubai, United Arab Emirates. Regulated by the Dubai Financial Services Authority.

202310-3193026-GL