

360 Perspectives

**Private assets
still attractive**

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The rise of inflation has been a defining moment for 2022. As inflation soared to levels unseen in decades and central banks around the world embarked on a largely synchronized bout of monetary tightening, the reality of higher interest rates has pushed both global equities and bonds into a bear market, a development unprecedented in recent history.

Amid the pervasive gloom in public markets, it is not unreasonable to have concerns that private market assets eventually follow suit. Private assets are no silver bullet against the macro challenges investors are confronted with this year - they are not immune to rising interest rates and come with their own specific risks.

Despite this, we continue to see reasons to include private assets in a long-term diversified investment strategy. Carefully managed exposure to these assets can generate portfolio benefits and higher returns than their public market counterparts across market environments. Notably, private assets are less exposed to the extreme emotional reactions that public markets are often subjected to. In a year of heightened public market asset volatility, private assets can be a source of relative calm and stability.

In this report, we explore various private assets and the benefits that they bring to a portfolio. We also investigate how private assets have historically performed during periods of rising interest rates and inflation as well as shifting stock and bond correlations, similar to what we see in markets today. We then conclude with a guide on how to consider inclusion of private assets into a portfolio.

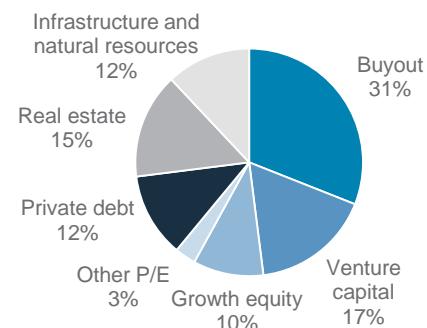
An alternative source of return

Private assets offer an alternative source of returns. Historically, (i) private equity has generally outperformed public equities over the long run, (ii) unlevered private real estate returns ranked between equity and bond returns, and (iii) private debt outperformed high yield bonds. These excess returns come from the asset class's exposure to a differentiated set of strategies and manager expertise, as well as compensation for illiquidity and complexity risk.

As such, we view private assets as a source of returns within opportunistic allocations and, hence, a complement to core

foundation allocations that comprise more traditional public market asset classes.

Fig. 1 Universe of private assets



Source: McKinsey Global Private Markets Review 2021

To be clear, some well-resourced investors with very long horizon and limited liquidity needs, such as endowment funds, tend to view investments in private assets as a core foundation allocation. This might be the case as some private assets, such as private credit, real estate and infrastructure, deliver a large part of their returns from stable cash flows which are often less correlated with, and face smaller drawdowns than, traditional asset classes over long periods.

However, in investing there are no free lunches, and it should be noted that the potential for higher returns in private assets are generally accompanied with additional risk exposures:

- Greater complexity:** The sourcing of deals to selection, execution as well as operational value-addition and exit strategies present risks and opportunities for managers. Investors need to exercise additional due diligence in understanding how managers create and capture value.
- Greater return dispersion:** There is often a greater variation in performance across managers and strategies in private markets relative to their public market peers.
- Illiquidity:** This is often a key feature of private assets and a driver for much of its excess return over public markets. It also means that investors are likely to face uncertainty in timing investment exits, necessitating the importance of aligning investment duration, commitment, and objectives.

Fig. 2 Private assets' risk-return profiles relative to public market peers

	Public market peers	Investment characteristics		
		Diversification	Income	Capital growth
Private equity	Public equities (DM)	Low	Low	High
Private credit	High yielding credit	Medium	High	Low
Private real estate	REITs	High	Medium	Medium

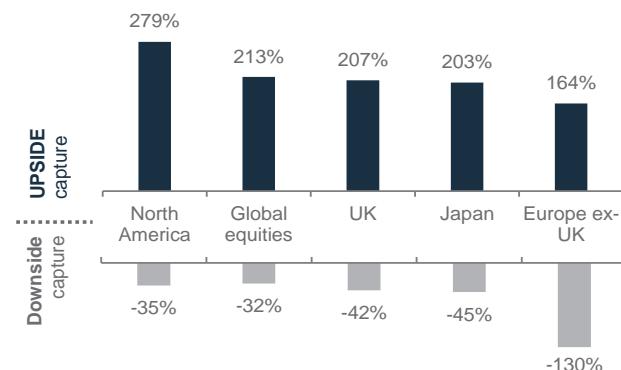
Source: Standard Chartered

Private equity as a return enhancer

Over the past 20 years, private equity (PE) has outperformed the US and global equity markets 64% and 65% of the time, respectively, based on 12-month rolling returns. In these last 20 years, 10-year US government bond yields have dropped from 6.0% in 2000 to about 1.5% earlier this year. The low yielding environment helped support leveraged buyouts, thereby contributing to its outperformance.

While limited in its ability to provide diversification for a traditional 60/40 portfolio, it makes up with its high upside capture potential and low downside capture relative to public market peers. An upside capture ratio of 213% with global equity means that, for every 10% gain in global equity gains, we were likely to see private equity deliver 21.3% over the same period. Thus, in periods of strong equity markets, substituting some global equity exposure with private equity to enhance returns can be considered.

Fig. 3 Historical upside/downside capture* ratios of private equity with various equity regions (2001 – 2020)



Source: Cambridge Associates, Bloomberg, Standard Chartered

*Upside/downside capture refers to the ratio of an asset's overall return to global equity market returns over periods when equities have risen/fallen.

Private debt as a source of high, stable income

The growth in private debt (PD) plays to the financing void which arose following the global financial crisis, as banks shifted to an intermediation role from their traditional role as lender due to a tighter regulatory environment. Private debt is typically a secured loan, but its terms are tailor-made between the borrower and a single or small group of lenders, thus rendering it illiquid. It can consist of lending to a corporate, real estate, infrastructure and listed or unlisted entities.

Over the past decade, private credit has been a reliable source of income while proving to be more resilient than traditional fixed income. It offers several advantages relative to High Yield (HY) bonds and bank loans, in our view: higher yield and limited mark-to-market volatility, generally higher returns and some protection against pre-payment. These,

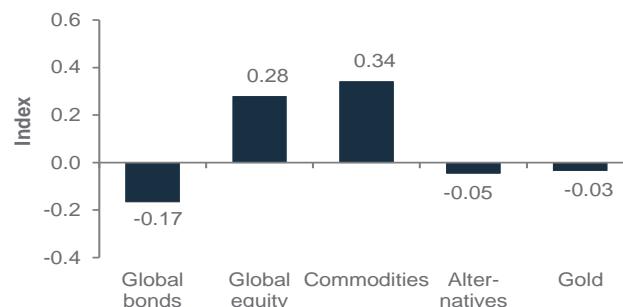
however, come at the cost of lower liquidity and more intensive monitoring requirements.

Private real estate valued for its combination of income and returns

Private real estate (PRE) captures both the characteristics of private equity (ie. capital appreciation) and private debt (ie. income). Looking forward, with inflation remaining a risk, we believe core real estate presents an attractive option for investors to satisfy their income needs while boosting a portfolio's resilience to higher inflation. Forward-looking data (Fig 4) show that private real estate is likely to be a powerful diversifier, offering negative to low correlation with public stocks and bonds.

Fig. 4 Forward-looking* correlations of private real estate with various asset classes

Expected correlations across assets



Source: Bloomberg, Standard Chartered. *based on our capital market assumptions

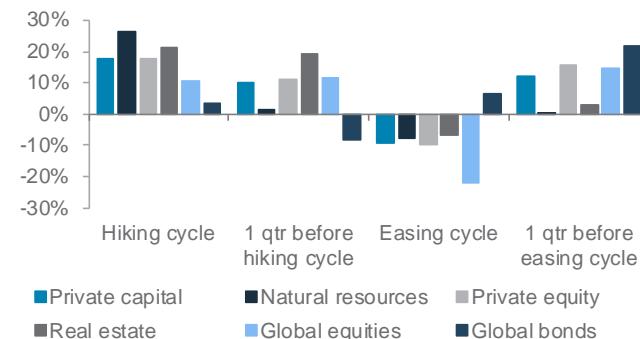
How have rising rates impacted private assets?

2022 has so far been a particularly challenging year for financial assets across the board. Amid persistently high inflation, global central banks have continued to embark on policy tightening, reiterating their hawkish stance even though this has put economic growth in a vulnerable spot. This has resulted in global equities declining into bear market territory and the 10-year US government bond yield soaring to 4%. While no major asset class has been spared the beating in the market, history shows that private assets have tended to perform well relative to global equities and global bonds during Fed hiking cycles.

Figure 5 below illustrates that, in periods of policy tightening, global equities and global bonds recorded annualized returns of 11% and 3.3% respectively. However, private assets like private equity, private capital, natural resources and real estate saw annualized returns of at least 17.6%. We attribute this to the fact that private assets are usually valued based on the fundamentals of the underlying companies and are less subject to mark-to-market volatility. Therefore, less volatility and lower correlation are expected in private assets because these investments are not traded in public markets.

Fig. 5 Performance of private assets, global equities and global bonds during Fed hiking and easing cycles

Averaged annualized returns for data from 2000 to 2021



Source: Bloomberg, Standard Chartered

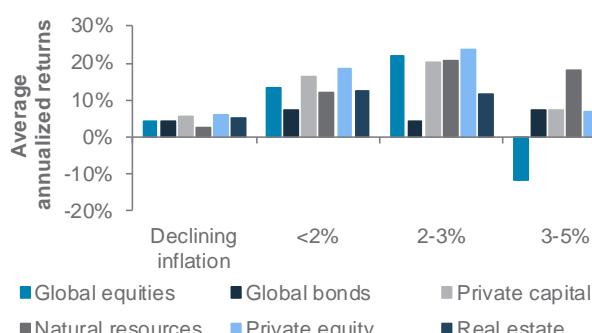
How do private assets perform under different inflation environments?

One of the challenges today is that inflation remains elevated. This may put certain private equity strategies in the difficult position of having to battle tighter liquidity and higher financing costs. However, an analysis of private equity performance under different inflation regimes shows that this does not necessarily bear out.

History shows that while global equities tend to decline in a rising inflationary environment, private equity strategies generally tend to still produce positive returns. Some private equity strategies which actively focus on infrastructure assets, natural resources or even real estate can provide active hedges against consumer inflation as commodity prices and leases/rents are typically linked to inflation, meaning they rise in line with rising consumer prices. Private assets tend to perform best during rising but mildly inflationary environments. However, their relative resilience during periods of high and rising inflation makes them a valuable addition to a diversified portfolio, in our assessment.

Fig. 6 Performance of private assets, global equities and global bonds in different inflation environments

Average annualized returns of private assets, global equities and global bonds in different inflation environments



Source: Preqin, Bloomberg, Standard Chartered

The shift in bond-equity correlation may impact private assets

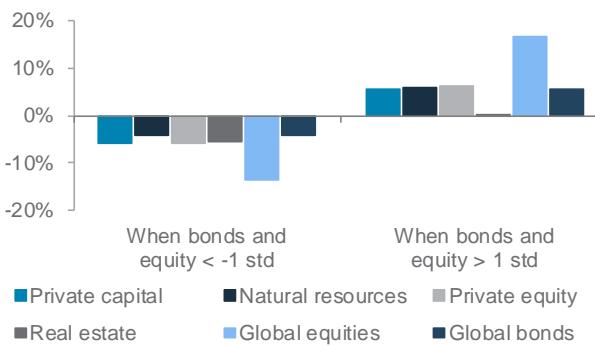
Another interesting phenomenon that we have witnessed this year is the positive correlation between equities and bonds, with both selling off in tandem. A review of the history of US financial markets shows us that over the past 150 years, there have been only four years –1931, 1941, 1969 and 2022 YTD – when US bonds and equities both declined simultaneously.

We analysed how private assets have performed historically under such a scenario. What we observe is that when bonds and equity returns record a move of less than -1 standard deviation, global equities are the worst performers, while private assets such as private equity, real estate and private capital have outperformed in relative terms by c.8%. Only natural resources outperformed global bonds.

While such occurrences are rare, we believe this history demonstrates the potential that private assets have to offer in mitigating volatility in one's portfolio in times of stress, while offering a long-term source of returns.

Fig. 7 Performance of private assets, global equities and global bonds during different degrees of equity and bond correlation

Average quarterly returns of other private assets when global bonds and equities are either higher by more than 1 SD or lower than 1 SD



Source: Bloomberg, Standard Chartered; SD = Standard Deviation

How to incorporate private assets in a traditional portfolio?

There is no one-size-fits-all solution to incorporate private assets into a traditional portfolio. The choice of the private asset category and the corresponding asset allocation decisions depend on one's investment objectives, intended horizon and liquidity constraints. For individual investors with sufficiently long horizons and limited liquidity needs, the following observations can be used as a guide:

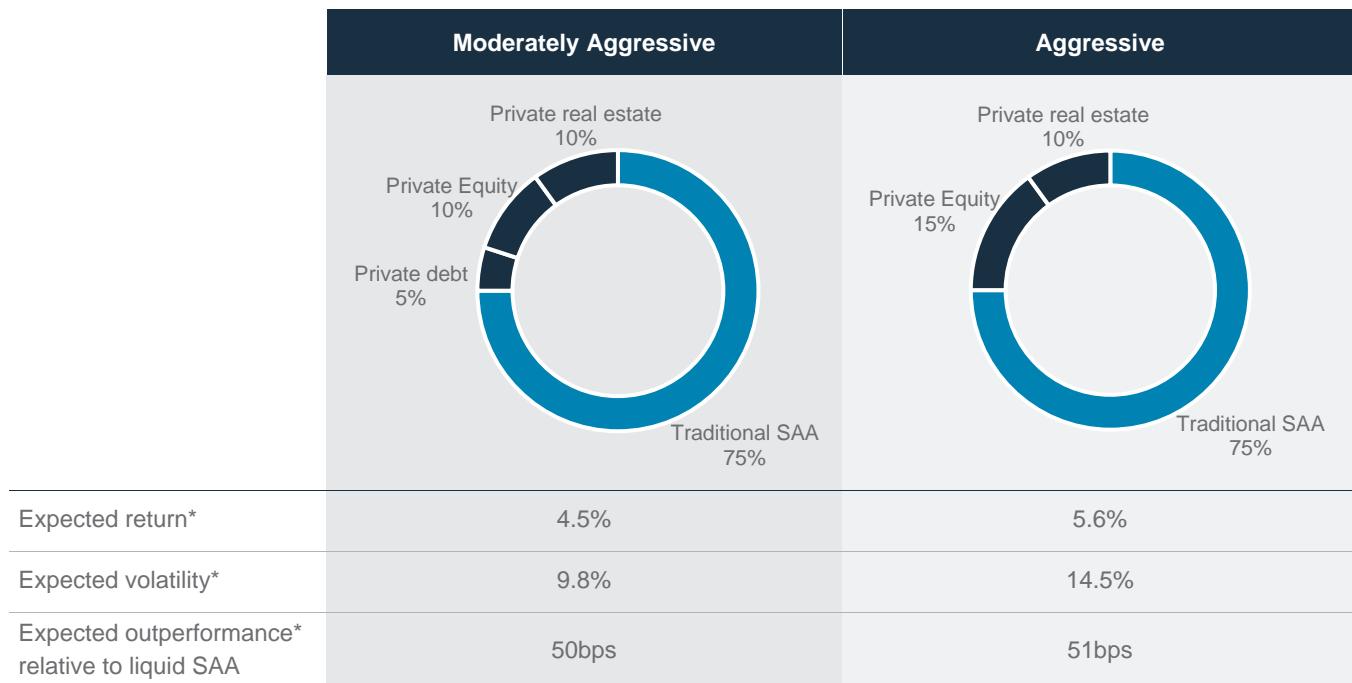
- Private assets can be treated as pockets of opportunistic investment in addition to one's core allocation. Incrementally introducing a small allocation of private assets into a fully diversified liquid allocation can allow investors to enjoy the benefits of private assets without overly compromising liquidity commitment and taking excessive risks.

The range of allocation to each private asset (PE, PD and PRE) is wide (5% for insurance plans to 35% for a sovereign wealth funds) according to various financial

institutions, with allocations likely to rise over time. It is also worth noting, though, that these institutions tend to have much longer investment horizons and a larger capital capacity to buffer potential illiquidity risks compared with individual investors.

- As a practical guide for individual investors allocating private assets in a traditional portfolio, we have used a combination of a quantitative framework (optimisation using historical and forward-looking capital assumptions) and a qualitative approach to generate suggested allocations of select private assets in a traditional strategic asset allocation across risk profiles. Results in figure 8 show that incorporating private equity, private debt and private real estate in a traditional portfolio is likely to improve returns (50bps per year), while potentially having lower total volatility.

Fig. 8 Suggested allocations of private assets in strategic asset allocations



Source: Bloomberg, Mercer, Standard Chartered; *based on our capital market assumptions

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