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Rethinking private equity allocation

June 2021

The traditional portfolio
is expected to earn a mere 4% annual return in the coming 7 years

Private assets are becoming an increasingly important part of an investor's portfolio. The traditional 60/40 global equity/bond portfolio is expected to earn a mere 4% annual return in the coming 7 years, according to our capital market assumptions, much lower than the 9% average annual return over the past 40 years.

Equity valuations are elevated and government bonds, which have been the reliable counterweight to equities in a market sell-off, are unlikely to provide the protection investors need going forward.

Against this backdrop, investors have looked to alternative investments to enhance returns, and Private Equity (PE) presents one such opportunity. In this section, we attempt to answer two questions investors commonly face when looking into this asset class:

Audrey Goh
Senior Investment Strategist

Trang Nguyen
Portfolio Strategist

How does PE perform compared to other asset classes? 1

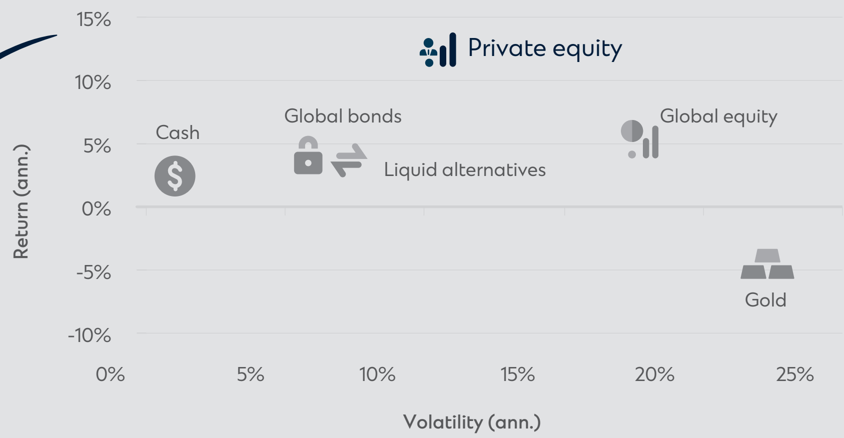
What is the appropriate allocation of PE in a portfolio? 2

How does PE perform compared to other asset classes?

PE as return enhancer

Historical data suggest higher risk-adjusted returns from PE

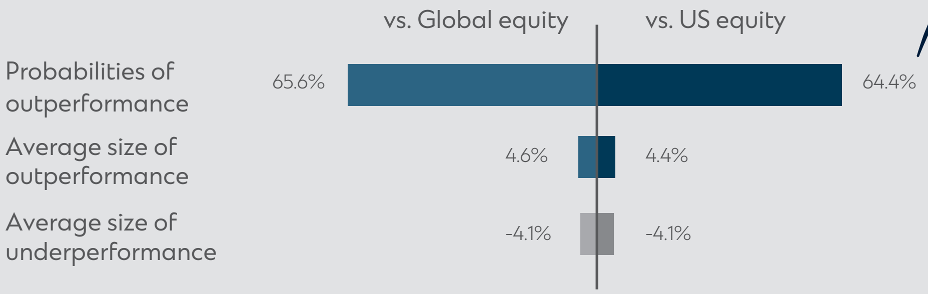
Annualised return/volatility (2000 to 2020)



PE appears to provide better risk-adjusted returns (returns per unit risk) compared to most key asset classes.

Probabilities of PE outperforming public equities have been relatively high

Quarterly returns data (2000 to 2020)



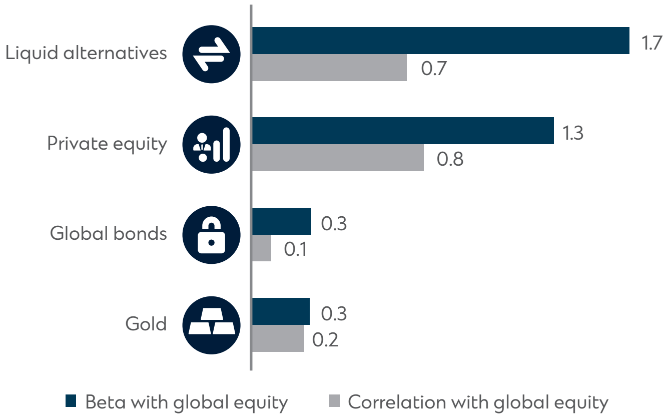
Over the past 20 years, it outperformed the US equity and global equity markets 64% and 65% of the time, respectively.

Source: Morningstar, Bloomberg, Standard Chartered

It is quite closely correlated to listed equities. This should not be a surprise as a PE firm typically values its assets on a comparable basis to those in the listed markets. While limited in its ability to provide strong diversification, it makes up with greater sensitivity (ie, beta) to any change in global equities. A beta of 1.3 suggests that for every 10% move in global equities, PE will move by 13%, making it a potential substitute for equity exposure if one seeks to generate higher returns, with historical data suggesting that PEs tend to perform strongly during periods of strong equity markets.

PE can be a useful substitute to public equity exposure

Beta and correlation coefficients with global equity (quarterly data from 2000 to 2020)



Source: Morningstar, Bloomberg, Standard Chartered

Returns in excess of listed equities could be driven by:

Liquidity premium, where an investor demands added compensation to lock capital for a long time, usually in excess of seven years. As private assets grow in popularity and accessibility, this source of return premia may well reduce, as quarterly, monthly or even daily liquidity becomes increasingly available.

Complexity premium/skill alpha, where the access to information and investments may be more limited. There could also be significant performance dispersion as the skill difference between managers to source, select, negotiate and exit investments, and to contribute to value generation becomes more pronounced.

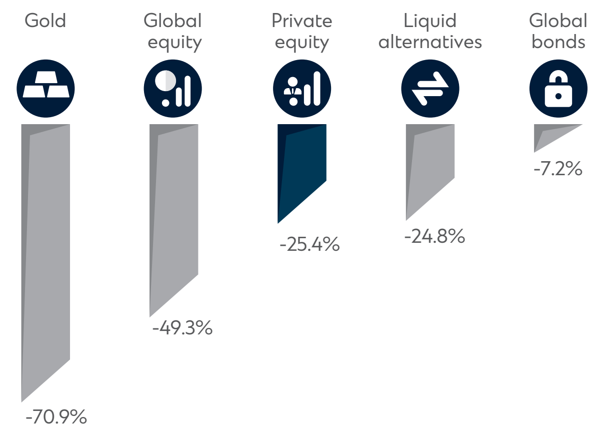
Resilient in the past crises

Looking at historical crises, PE has generally experienced significantly smaller drawdowns and has had a faster recovery than public equities. Some might argue that the opaque and illiquid nature of underlying assets can lead to an underestimation of potential downside risks.

In our opinion, this illiquid characteristic of PE may encourage investors to focus more on long-term investing and allow managers to be more selective in their deal sourcing and exit management. This is especially important during times of crises, where opportunities abound and PEs, with the ability to take positions in out-of-favour companies or sectors, can create value with their operation expertise and stand to reap outsized returns as the economy recovers.

PE saw lower pullbacks during the past market crashes

Maximum drawdown since 2000



Source: Morningstar, Bloomberg, Standard Chartered

What is the appropriate allocation of PE in a portfolio?

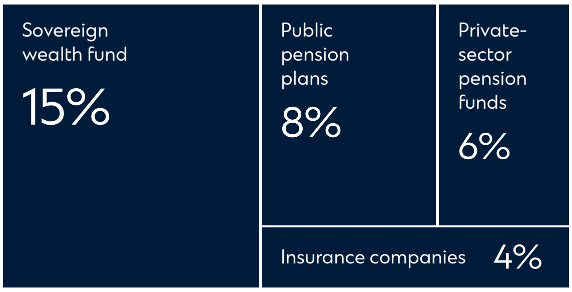
For investors with a sufficiently long horizon and limited liquidity needs, an allocation to PE can help to improve the overall risk/return profile of an investment allocation.

How much to allocate will depend on one's investment objectives, intended horizon and liquidity constraints. Looking at various investors' allocation to PE, we find the following:

- Ranges of allocation to PE across financial institutions is wide (4% for insurance plans to 15% for a sovereign wealth fund), with allocations likely to rise over time, according to an investor poll by Preqin. It is worth noting that these institutions tend to have much longer investment horizons and a larger capital capacity to buffer potential illiquidity risks compared to regular individual investors.
- As a rule of thumb, we advocate a measured 5-15% allocation to PE. For one, navigating the world of investing in PE can be complex and often opaque. Performance can also vary vastly between one manager to another, resulting in wide dispersion in returns, in addition to the illiquid nature of the investments, which lock capital for a period of 7-10 years. Any reduction in USD liquidity may also pose risks to future returns in Private equity.
- However, if an investor has high risk tolerance and wants to achieve higher returns, one potential option is to consider implementing part of one's equity allocation via PE, assuming he or she has limited liquidity needs. Using historical data, Figure on the right showcases the benefits of substituting global equity exposure (in a 60% equity and 40% bond) with different levels of PE allocation.
- Incorporating PE into a 60 equity/40 bond allocation can help enhance a portfolio's return at a lower level of risk. Our optimisation results show for a diversified allocation with risk budgets of 16% (which can be a good proxy for a Moderately Aggressive profile); an allocation between 15% and 20% to PE is likely to improve the overall risk/return profile of an allocation.

Allocation to PE varies across institutions

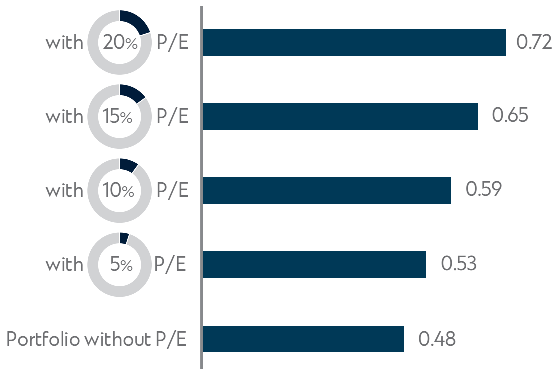
Average holdings of PE by various investors



Source: Preqin, Standard Chartered

Adding PE to a 60/40 portfolio helps improve the overall risk/return profile

Unit of return per unit of risk (2000 to 2020)



Source: Morningstar, Bloomberg, Standard Chartered

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