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Why Private Markets

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Key takeaways

- Allocating to private markets involves investing equity or debt capital in companies or assets that are not publicly traded
- Private markets have historically outperformed public market equivalents due to a range of factors, including the broader investment landscape, information inefficiencies, and operational control
- For investors who can bear the increased illiquidity and higher fees, Wilmington Trust advises a 20% allocation to private markets, which can improve the relative risk/return profile of a traditional portfolio

What goes into a well-diversified investment portfolio? Many investors are broadly familiar with public stocks and bonds, traditional asset classes that are highly liquid with real-time market pricing. These investments are often accessible, approachable, and widely held. Many investors may also hold other assets, like real estate or collectibles that are less liquid and don't offer a definitive market price but are broadly accessible. Private markets, though, remain largely underrepresented in the portfolios of many qualified investors.[1] These investment opportunities are not available to all market participants and come with distinct challenges, including illiquidity, high investment minimums, and limited transparency. Despite these hurdles, many of the most sophisticated institutional investors are allocating to private markets at higher and higher levels.

For clients who can bear the illiquidity, private markets have historically delivered outsized returns relative to public markets, and in our view, current markets are poised to support this trend moving forward. Public markets remain expensive, with returns driven by a select few of the largest companies. Private companies are also entering public markets later in their lifecycle than earlier generations of their predecessors, creating a differentiated set of investment opportunities in private markets versus public counterparts. For these reasons, among others, we advise many of our clients with sufficient assets and liquidity to allocate at least 20% of their portfolio to a mix of private equity, private debt, and real estate depending on a client's individual goals, risk tolerance, liquidity needs, and other circumstances.

[1] Qualified investors are required to meet minimum income and asset requirements set forth by the Securities and Exchange Commission.

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Private markets at a glance

Private markets are investments that involve investing equity or debt capital in companies or assets that are not publicly traded. These strategies often involve the use of leverage (borrowed money), long capital lockups that may last 10+ years, and limited transparency for investors and regulators. This is why private markets strategies are only offered to qualified purchasers, often at higher investment minimums. (For more background, see Private Markets: A Primer.)

Private markets investment opportunities can generally be categorized as private equity, private real estate, private debt, or niche strategies:

Private equity

Venture capital
Investing in startups with limited operating history and with the hope of outsized returns from a select few investments that may be successful

Growth
Providing capital through minority investments in businesses to aid in future developments/growth initiatives

Buyout
Purchasing controlling stakes in companies, with the goal of improving operations and growing the business to increase firm value

Private real estate

Core
Stable, high-quality assets expected to produce steady income with minimal capital improvements

Core plus
May benefit from slight improvements due to age or management inefficiencies

Value-add
Some type of required investment to achieve cash generation potential

Opportunistic
Ground up development, heavy repositioning, or investments outside established markets

Private debt

Direct lending
Providing senior loans to private companies, often to support corporate activity

Mezzanine financing
Making subordinated loans while often also taking an equity interest in the company

Distressed debt
Investing in the discounted obligations of companies that are or are likely to experience default where the investor believes the underlying assets or a turnaround can provide a gain on initial investment

Special situations
Broad credit investments focusing on a variety of complex situations that can cause dislocation in pricing or require special expertise or creative capital solutions

Niche

Unique assets with distinct risk versus return characteristics. Examples of niche opportunities in private markets:

- Infrastructure
- Mining
- Life settlements
- Farmland
- Art
- Music royalties
- Aviation leasing
- Timber
- Litigation finance

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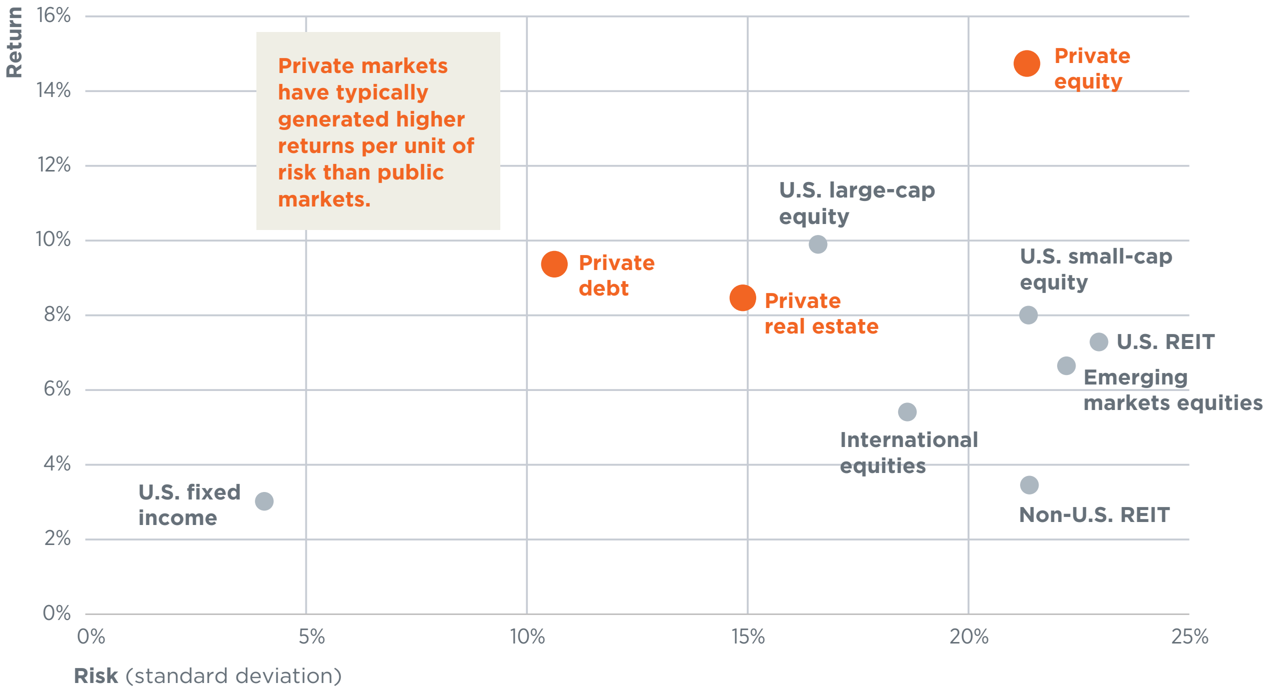
Figure 1

Private markets have historically generated higher return than public markets

Asset class risk-return



Data range is 10/1/2004–6/30/2023.

Sources: Bloomberg, Cambridge, Cliffwater Direct Lending Index (CDLI), Wilmington Trust Investment Advisors, Inc. (WTIA).

Investing involves risks, and you may incur a profit or a loss. Past performance cannot guarantee future results. Indices are not available for direct investment. Investment in a security or strategy designed to replicate the performance of an index will incur expenses such as management fees and transaction costs, which will reduce returns.

The asset classes shown are represented by these indices: U.S. large cap (Russell 1000 Index); U.S. small cap (Russell 2000 Index); international equities (MSCI EAFE [net] Index); emerging markets equities (MSCI Emerging Markets [net] Index); U.S. fixed income (Bloomberg U.S. Aggregate Bond Index); U.S. real estate investment trusts (REIT) (S&P United States REIT Index); Non-U.S. REIT (Dow Jones Global Select Real Estate Securities Index); private equity (Cambridge US Private Equity Index); private real estate (Cambridge Private Real Estate Index); private debt (Cliffwater Direct Lending Index). For definitions of each index, please see the Glossary in the Disclosures.

Private markets up close

Private markets vs. public markets

When investors allocate to private markets, they generally must be willing to tolerate additional complexities to access an asset class that has historically outperformed public markets on an absolute and risk-adjusted basis (Figure 1). Relative to a public market equivalent, which is a way to compare public and private markets investment performance by matching investment and distribution cash flows in the private market to a public equity market benchmark, private equity continues to maintain a significant performance edge across time periods (Figure 2).

The reasons for private markets' consistent outperformance are manifold and include both inherent structural advantages as well as shorter-term market dynamics that create compelling investment opportunities. Structurally, private markets represent a far wider landscape of investable opportunities than is typically available in public markets, including unique assets that are challenging to build into vehicles that are easily publicly traded.

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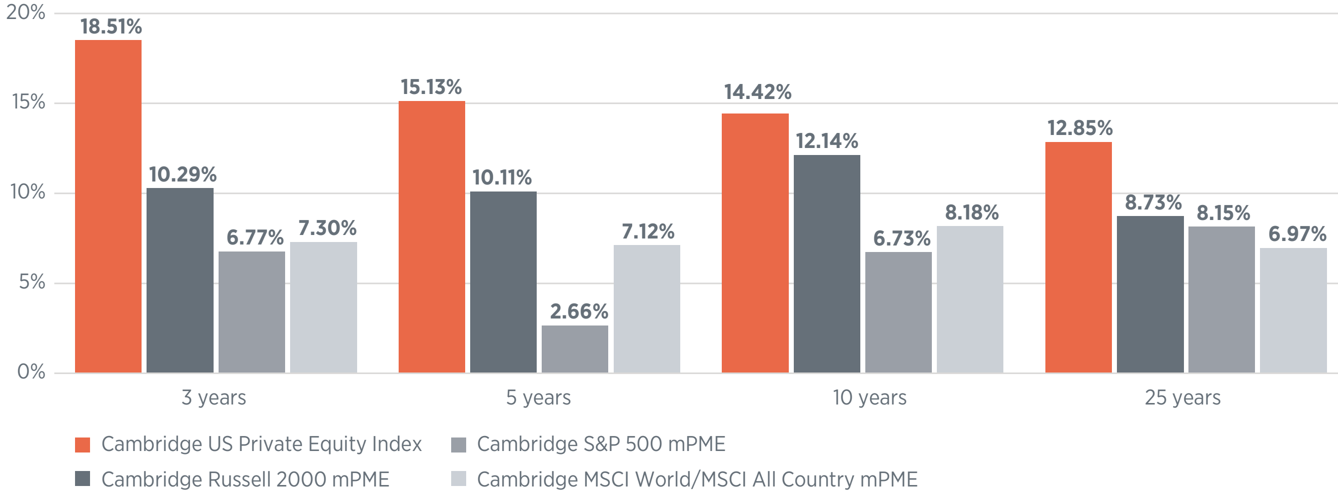
Figure 2

Historically, private equity has outperformed relative to modified public market equivalents

Annualized returns of private equity vs. modified public market equivalents (mPME)



Data through 9/30/2023.

Source: Cambridge.

Horizon calculation based on data compiled from 1,953 funds, including fully liquidated partnerships, formed from 1986 to 2023. For a description of modified public market equivalent and indices mentioned, please see the Glossary.

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Most investors, though, will be more familiar with more mainstream investments in private markets, which often center around a company providing a good or service much like a public company does, often just at a smaller scale or at an earlier stage. In these instances, private fund investment managers (the general partners, or GPs) have an advantage relative to their public peers, deploying smaller pools of capital in a far wider investable universe (Figure 3).

While the amount of capital deployed in private markets has grown over the previous decades, the asset class remains a small fraction of the size of public markets. Despite this differential, and the fact that valuations of public stocks continue to increase, the number of publicly traded companies has declined significantly over time, limiting the opportunity set for public investment.

Private markets are also inefficient as it pertains to the flow of information and price discovery. While public assets are priced in real time as stocks and bonds trade, private companies are generally illiquid, changing hands very rarely, if at all. Gathering information to make informed pricing decisions is much more capital intensive than in public markets, where regulations standardize the disclosing of information and numerous professionals are following every company.

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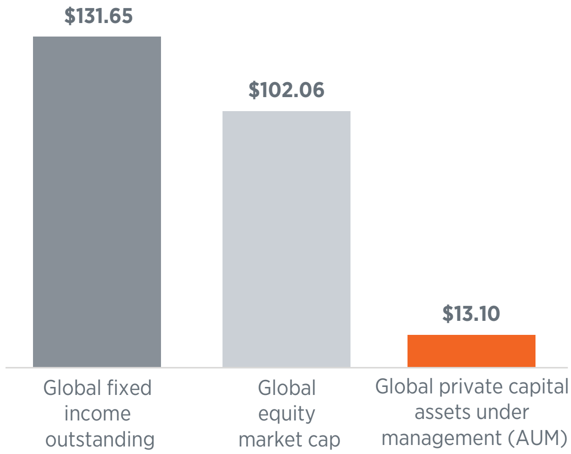
Figure 3

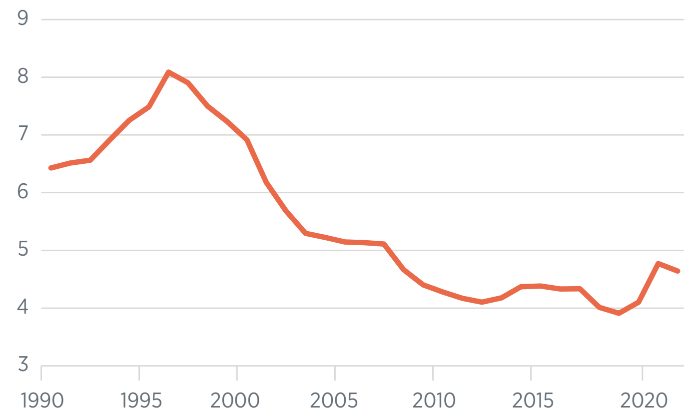
Despite growth, private markets remain approximately 1/20th the size of public markets...

Size of public and private markets (trillions)



...and continue to represent an increasingly large percentage of U.S. businesses

Number of U.S. listed companies (thousands)



Source: Bank of International Settlements for fixed income data, Bloomberg for equity data (as of 4/11/2024), McKinsey 2023 Private Markets Annual Review for private capital, World Bank's World Development Indicators Listed Domestic Companies Total for company count (as of 1/1/2022).

Relative to U.S. large-cap equity markets, which are highly efficient transmitters of information, private markets represent the exact opposite, a highly inefficient marketplace with greater upside for those with the resources required to identify the right opportunities in the space. More so than in public markets investing, private markets expertise and experience may be challenging to replicate, creating a natural moat around talented firms.

Unlike public markets, where even large shareholders are constrained in their operational control of a company, private equity investors have the ability to exert significant operational control when necessary to help drive value. Sponsor-backed companies (companies controlled by private equity or debt GPs) often benefit from the significant resources of their sponsor, whether it be additional capital, investment/operating expertise, or deep industry contacts. Sponsors can help provide or obtain financing or renegotiate debt in challenging environments, upgrade management teams as needed with proven professionals, or create plans for go-forward growth that may be outside of the ability of the existing senior leadership.

One drawback of private markets investing is illiquidity: capital may be locked up for extended periods of time, ranging from five to 12 years, depending on the strategy. For certain investors, the inability to withdraw capital makes private markets unattractive. For those who can tolerate it, though, the inherent illiquidity of a private markets fund can create opportunities for return enhancement.

GPs are able to take true long-term approaches to portfolio company improvements and capital deployment, unencumbered by the

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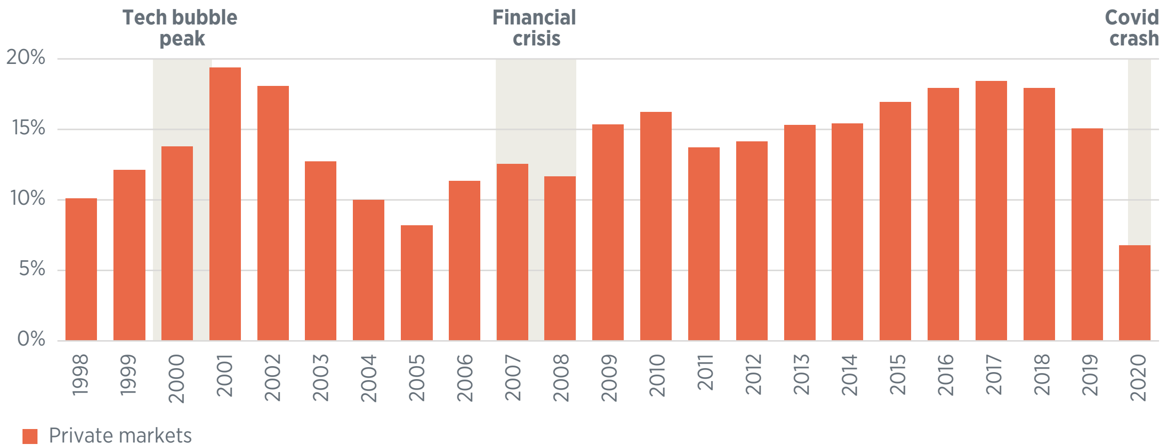
Figure 4

Private equity funds have benefited from deploying into troubled macroeconomic environments

Median since inception internal rate of return (IRR), net to limited partners (LPs)



Source: Cambridge US Private Equity Index, as of 9/30/2023. Median since inception IRR.

Past performance cannot guarantee future results.

quarter-to-quarter public reporting cycle. They can be nimbler during periods of uncertainty knowing that investors are unable to "panic sell" at the most inopportune times to exit an asset, instead deploying when others are pulling back. In fact, the best-performing private markets vintage years are frequently those that were launched in challenging macroeconomic environments and stood to deploy capital into weak markets (Figure 4). In a similar vein, GPs have control over their exit timing and can hold assets for longer than originally intended if the market turns and valuations are pressured, waiting to sell into a more favorable environment.

More recent developments in public markets are also creating opportunities for private fund managers to generate alpha. First, and perhaps most obvious on a day-to-day basis, is that the most heavily traded public markets like U.S. large-cap equities (think S&P 500 stocks) have grown increasingly top-heavy with massive amounts of capital chasing the same handful of names. This has the potential to drive up prices beyond what might be justified based on business fundamentals alone. With less capital chasing a far larger pool of companies, valuations in private markets may be more reasonable, leaving more room for upside at exit.

The shrinking size of public markets discussed earlier can be attributable to a number of simultaneous factors (the increase in mergers and acquisitions, the growing capital in private equity targeting take-private opportunities, etc.), but is at least partially due to the recent growth in venture capital. Particularly in the U.S. (as discussed in "U.S. Exceptionalism: The Private Markets Advantage,") the venture capital ecosystem has created an alternative source of funding for companies at their earliest stages, many of which may not even have working products or services developed.

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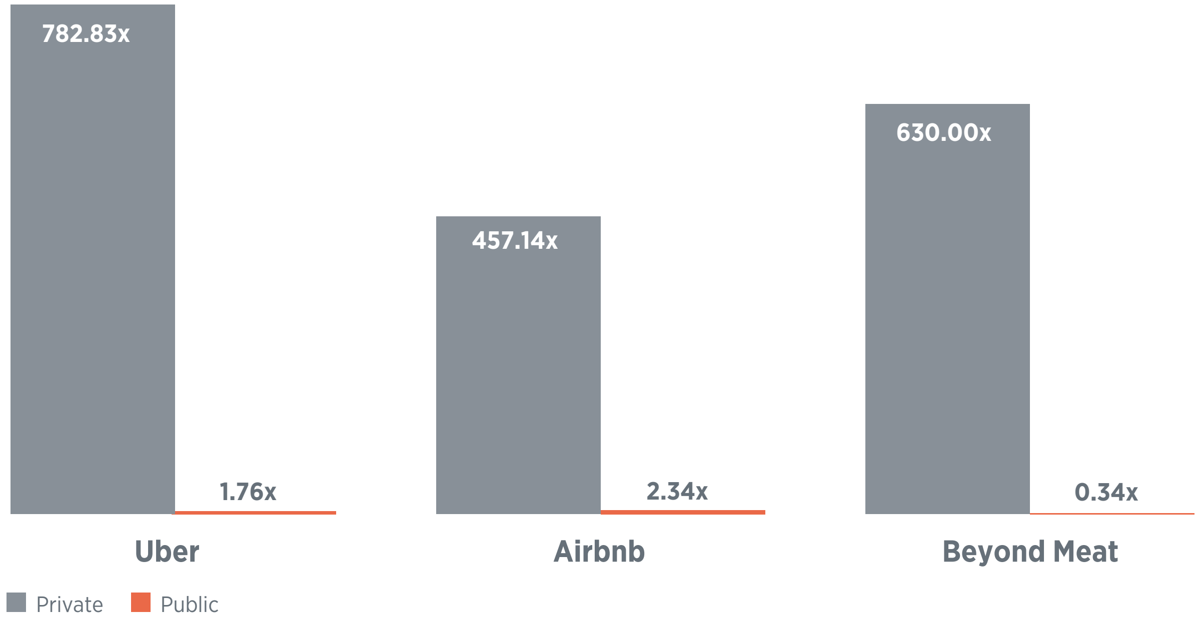
Figure 5

Recent high-profile initial public offerings (IPOs) have produced underwhelming returns on investment for investors who bought in at the IPO

Private versus public return on investment (price multiple)



Sources: Pitchbook, Bloomberg. Private returns calculated from Series A fundraising round through IPO price. Public return IPO price through 2/29/24 closing price.

A price multiple is a ratio that uses a company's market capitalization and divides by the sum of a specific financial metric. The ratio for the private price multiple defined here is the IPO valuation less capital raised all over the Series A valuation. The public price multiple defined here is the IPO opening price divided by the closing price on 2/29/2024.

Investors here are often more tolerant of uncertainty and help to promote and provide access to the next generation of emerging technologies, all occurring outside of the public markets. Early-stage companies are certainly riskier, and while some inevitably fail, those that do succeed tend to have higher growth rates that naturally slow as companies mature. Though in the past it was common for companies to go public as a source of continued funding once they reached a stage of relative acceptable maturity, the growth of available private capital over the last decade has removed some of the urgency of going public. Some hallmark private companies, like SpaceX, have opted to stay private far longer as compared to older peers like Amazon, which went public only a few years into its life—well before it achieved significant success.

Newly public companies are frequently viewed by investors with excitement initially, driving up the entry multiple, sometimes beyond what is reasonable based on the company's operating performance. Unlike earlier IPOs, many much-anticipated public offerings have accrued far more value for early-stage private investors than for those who were able to access the company only through the public market (Figure 5).

Core narrative

Over the long term, we believe that adding private markets to a portfolio may provide the potential for increased returns without a significant increase in overall portfolio volatility (Figure 6). Wilmington Trust advises

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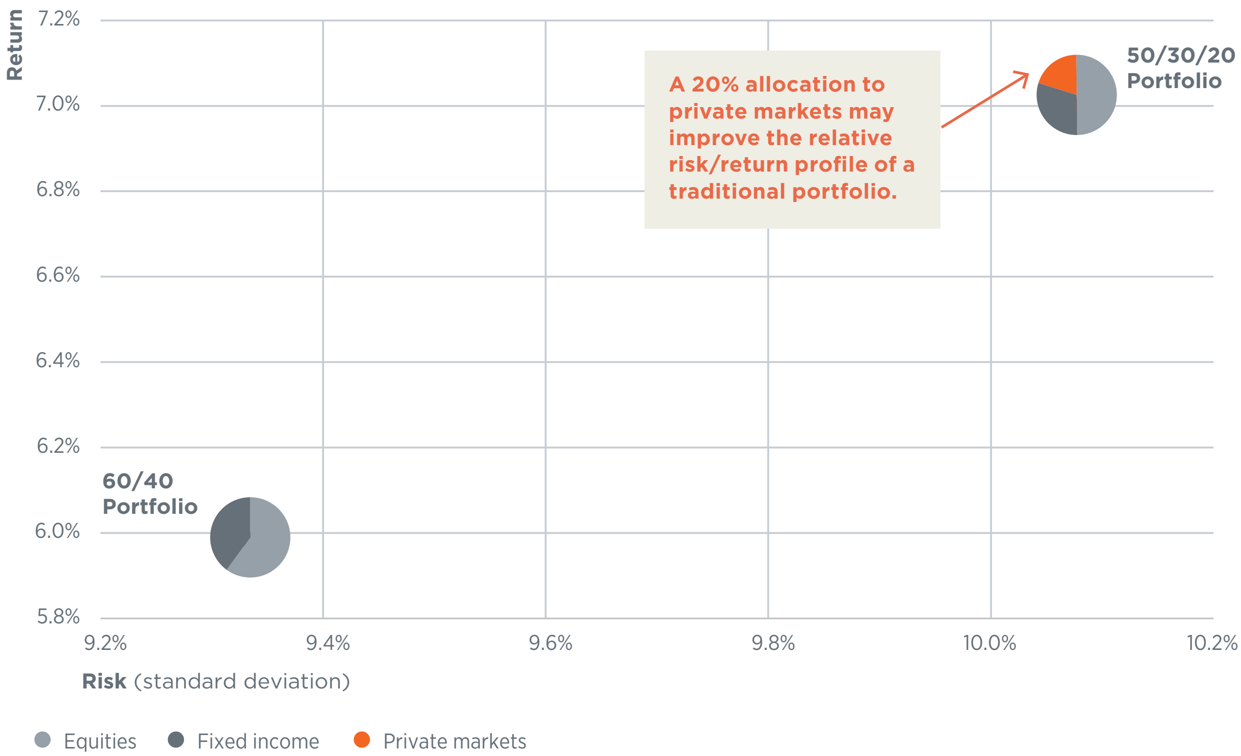
Figure 6

The power of a diversified portfolio

Portfolio risk/return expectations



Sources: Bloomberg, Wilmington Trust 2023 Strategic Asset Allocation expected risk/return forecasts. 60/40 portfolio is 60% Russell 1000 Index, 40% Bloomberg U.S. Aggregate Bond Index. 50/30/20 portfolio is 50% Russell 1000 Index, 30% Bloomberg U.S. Aggregate Bond Index, 20% private markets (10% private equity, 5% private real estate, 5% private debt).

Investing involves risks, and you may incur a profit or a loss. Past performance cannot guarantee future results. Indices are not available for direct investment. Investment in a security or strategy designed to replicate the performance of an index will incur expenses such as management fees and transaction costs, which will reduce returns.

Diversification cannot ensure a profit or guarantee against a loss.

This chart is for illustration purposes only and does not reflect the actual past or future performance of any specific investment. The illustration is hypothetical and is intended solely to depict how diversifying a portfolio with private markets may improve the relative risk/return profile of a traditional portfolio.

a private markets allocation of at least 20% of a diversified portfolio, depending on a client's individual goals, risk tolerance, liquidity needs, and other circumstances. For large institutions that can bear higher levels of illiquidity, private markets allocations may be far higher, constituting 50% of a total portfolio for some of the largest endowments and foundations.[2]

Investing in private markets requires tradeoffs relative to a portfolio made up solely of public assets. Limited investor control, higher minimums and fees, and uncertain deployment of committed capital are challenges that investors must consider. For many qualified investors, though, education can help alleviate some of these concerns, making the buildout of a dedicated private markets allocation more approachable.

We believe that private markets are likely to continue their track record of outperformance, fueled by a less efficient market and significant operational control. A successful private markets program can provide a return premium to traditional public markets portfolios with limited correlation to other asset classes. Talk to your investment advisor about your unique circumstances to assess whether private markets might be a smart enhancement to your portfolio.

[2] 2023 NACUBO-Commonfund Study of Endowments.

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Private funds are available only to certain investors who meet the specific income, experience, and investable assets thresholds set forth by the U.S. Securities and Exchange Commission's definition of accredited investors and/or qualified purchasers as necessary. In addition, any offer of such products will be made only in connection with the delivery of the appropriate offering documents, which are available to prequalified persons upon request. Investments such as private funds and mutual funds that focus on alternative strategies are subject to increased risk and loss of principal and are not suitable for all investors. These types of investments may use aggressive investment strategies, which are riskier than those used by typical mutual funds, and you may lose more money than if you had invested in another fund that did not invest as aggressively. You are encouraged to seek professional investment advice prior to making any investment decision. In addition, nothing relating to the material provided should be construed as a solicitation, offer, or recommendation to engage in any investment strategy or other transaction.

The main risks of private equity funds that may reduce returns are described below and are in addition to the individual risks associated with the asset classes private funds may hold.

Information: The investment manager relies on information provided by third-party resources, underlying funds, and their managers. If tools/data used in managing a strategy prove incorrect, decisions made in reliance on them may not produce desired results and the strategy may realize losses.

Limited control: Investors in private equity funds generally have no authority to make or influence decisions made by the investment manager. Their investments in a fund represent their willingness to entrust all aspects of the investing activities to the investment manager.

Liquidity: Investors may be unable to convert (sell) their holdings into cash in a timely manner without affecting the market price or contributing to other unfavorable economic conditions.

Market: The value of securities in the fund's portfolio will fluctuate; therefore, their share prices may decline suddenly or over a sustained timeframe.

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GLOSSARY

Alpha is the excess return of an investment, relative to the return of a benchmark index.

Bloomberg U.S. Aggregate Bond Index is a broad-based, market capitalization-weighted bond market index representing intermediate-term investment-grade bonds traded in the U.S., often used as a stand-in for measuring the performance of the U.S. bond market.

Cambridge Associates Modified Public Market Equivalent (mPME) is a private-to-public comparison that seeks to replicate private investment performance under public market conditions. The public index's shares are purchased and sold according to the private fund cash flow schedule, with distributions calculated in the same proportion as the private fund, and the mPME NAV (the value of the shares held by the public equivalent) is a function of mPME cash flows and public index returns. The mPME attempts to evaluate what return would have been earned had the dollars been deployed in the public markets instead of in private investments while avoiding the "negative NAV" issue inherent in some PME methodologies.

Cambridge MSCI World/MSCI All Country mPME is a constructed index. Data from 1/1/1986 to 12/31/1987 represented by MSCI Index gross total return. Data from 1/1/1988 to present represented by MSCI ACWI gross total return. The index shares are purchased and sold according to the private fund cash flow schedule, with distributions calculated in the same proportion as the private fund, and mPME net asset value (NAV) is a function of mPME cash flows and public index returns.

Cambridge Private Real Estate Index is a horizon calculation based on data compiled from 1,186 real estate funds, including fully liquidated partnerships, formed between 1986 and 2019. All returns are net of fees, expenses, and carried interest.

Cambridge Russell 2000 mPME – Cambridge Analytics Modified Public Market Equivalent (mPME) indices replicates private investment under public market conditions. The Russell 2000 shares are purchased and sold according to the private fund cash flow schedule, with distributions calculated in the same proportion as the private fund, and mPME net asset value (NAV) is a function of mPME cash flows and public index returns.

Cambridge S&P 500 mPME – Cambridge Analytics Modified Public Market Equivalent (mPME) indices replicates private investment under public market conditions. The S&P 500 shares are purchased and sold according to the private fund cash flow schedule, with distributions calculated in the same proportion as the private fund, and mPME net asset value (NAV) is a function of mPME cash flows and public index returns.

Cambridge US Private Equity Index is a horizon calculation based on data compiled from 1,953 funds, including fully liquidated partnerships, formed between 1986 and 2003. Private indexes are pooled horizon internal rate of return calculations, net of fees, expenses, and carried interest.

Cliffwater Direct Lending Index is a private bank-loan strategy that can be used as a rough proxy for private debt investments.

Dow Jones Global Select Real Estate Securities Index is designed to measure the performance of publicly traded real estate investment trusts (REITs) and REIT-like securities and is a subindex of the Dow Jones Global Select Real Estate Securities Index (RESI), which seeks to measure equity REITs and real estate operating companies (REOCs) traded globally.

MSCI EAFE (net) Index measures the performance of approximately 20 developed equity markets, excluding those of the U.S. and Canada. The total returns of the index are net of the maximum tax withholding rates that apply in many countries to dividends paid to nonresident investors.

MSCI Emerging Markets (net) Index measures the performance of approximately 25 developing equity markets. The total returns of the index are net of the maximum tax withholding rates that apply in many countries to dividends paid to nonresident investors.

Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 92% of the total market capitalization of the Russell 3000 Index. As of its latest reconstitution, the index had a total market capitalization range of approximately $1.3 billion to $309 billion.

Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. As of its latest reconstitution, the index had a total market capitalization range of approximately $128 million to $1.3 billion.

S&P United States REIT Index measures the investable U.S. real estate investment trust (REIT) market and maintains a constituency that reflects the market's overall composition.