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The Case for Unconstrained Multi-Asset Portfolios: Navigating the Challenges of Public-Private Investing

Adding private markets to portfolios has generally been shown to enhance return potential, diversification and overall portfolio efficiency. As investors allocate more to private markets, many are recognizing the challenges that come with combining the management of private and public assets in a genuinely integrated portfolio.

In this paper we discuss how utilizing a multi-asset manager to provide such an integrated, unconstrained portfolio has the potential to enhance portfolio construction and risk management, make governance lighter and more cost-efficient, help mitigate the "j-curve" of traditional private markets investing, and encourage a more opportunistic approach to investing along the full liquidity spectrum.

Executive Summary

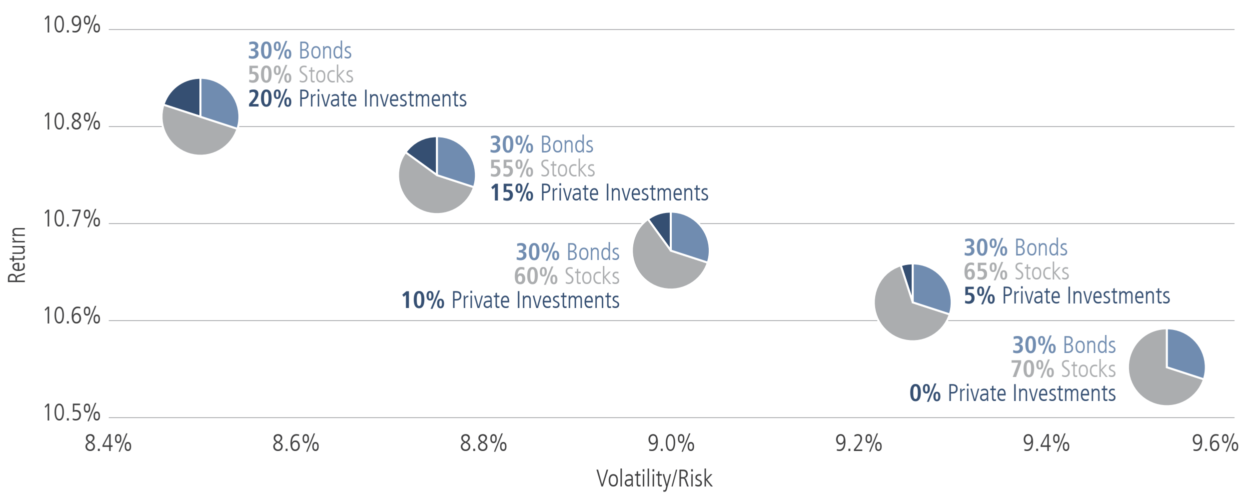
- The potential benefits of adding private markets to portfolios from a return, diversification and overall portfolio efficiency perspective are readily apparent.
- As investments in private markets continue to grow, many allocators are facing newer challenges associated with combining private investment with public within a single portfolio.
- In this paper, we discuss how using an unconstrained multi-asset approach to gain public-private exposure has the potential to enhance portfolio construction and risk management within a cost-efficient, low governance framework.
- Furthermore, multi-asset managers may be able to provide a more opportunistic approach to private markets investing when given the broad latitude to invest across the liquidity spectrum, seizing market opportunities and reducing the "j curve" effect of traditional private markets investing.
- Finally, partnering with an asset manager with extensive resources and specialist capabilities can further the development of investors' own public-private portfolios, through the sharing of knowledge, ideas and best practices.

The potential benefits of adding private assets into an investment portfolio are readily apparent. Private markets have tended to provide access to potentially higher-returning opportunities, due to illiquidity and complexity premia and the more growth-oriented profile of private companies. Asset classes such as private credit, real estate and infrastructure also offer access to different sources of yield potential. We believe private markets' potential for diversification can improve risk-adjusted portfolio return profiles (figure 1).

Many investors are increasing their allocations to these assets as they face low return outlooks, higher volatility, more severe drawdowns from traditional liquid markets, and rising equity-bond correlations as yields rise and public stock market valuations fall in tandem. The data from a recent survey by Nuveen, the asset management division of the Teachers Insurance and Annuity Association of America-College Retirement Equities Fund (TIAA), suggested a strong trend toward investing in illiquid alternatives by institutional investors around the world, including the biggest ever planned year-on-year increase in allocations to private credit (figure 2).

FIGURE 1. ADDING PRIVATE ASSETS HAS RAISED PORTFOLIO RETURNS BUT LOWERED VOLATILITY

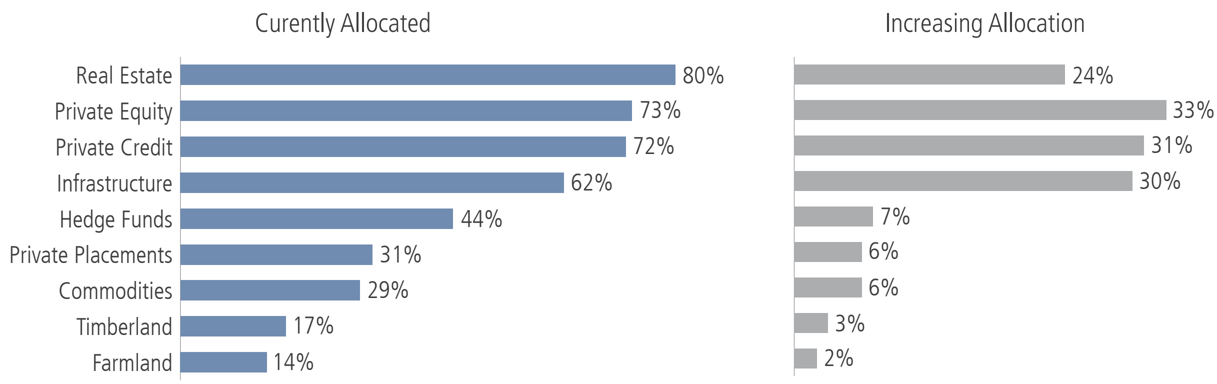
Portfolio risk and return profiles with increasing allocations to private investments (60% private equity, 20% private debt, 20% private real estate), December 2009 – December 2021



Source: Neuberger Berman, Bloomberg-Barclays, MSCI, Cambridge Associates. Data as of December 31, 2021.
For illustrative and discussion purposes only and does not constitute an offer or solicitation with respect to the purchase or sale of any security. Any investment decision with respect to an investment in a private fund should be made based on the information to be contained in the private placement memorandum and the limited partnership agreement of the applicable fund. Past performance is not indicative of future results. Bonds represented by the Bloomberg Global Aggregate Index. Stocks represented by the MSCI ACWI Index. Private Investments include 60% private equity (represented by the Cambridge Associates Global Private Equity Index), 20% private debt (represented by the Cambridge Associates Global Private Debt Index), and 10% real estate (represented by the Cambridge Associates Global Real Estate Index). Indices are unmanaged and not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is not indicative of future results.**

FIGURE 2: INVESTORS APPEAR POISED TO SHIFT EVEN FURTHER TOWARD ALTERNATIVES

Proportion of surveyed institutional investors worldwide that are allocating, and plan to increase allocations, to alternative investments



Source: Nuveen, *Think Equilibrium* 2022 Global Institutional Investor Study. Nuveen and CoreData surveyed 700 asset owners and 100 consultants spanning North America, Europe, the Middle East, Africa and the Asia Pacific region in October and November 2021. Asset owner survey respondents represented organizations with assets of at least $500m, and 55% had assets greater than $10 billion.

As these allocations grow, they create new challenges. Portfolio construction and risk management becomes more complex, diverse liquidity and cash-flow profiles need to be aligned, and different reporting standards need to be integrated. Overall, this adds to the governance burden on most investors.

We believe that utilizing a multi-asset manager to provide a genuinely integrated, unconstrained public-private markets portfolio can ease these challenges while providing unique advantages to maximize portfolio efficiency.

Managing the Complexity of Diversified and Customized Portfolios

The first advantage that a multi-asset manager can bring is intuitive: a larger organisation with a broader range of expertise is more likely to be able to identify attractive return opportunities from a more diverse set of markets and asset classes, broadening the opportunity set and helping to enhance portfolio diversification.

Multi-asset managers accomplished in private markets can further customise and diversify portfolio exposures within private-asset allocation—for example, by vintage year, style, geography and sector. A multi-asset mandate can be designed to complement investors' existing exposures and commitments, providing access to more specialist areas of the market and enhancing diversification. Though investors can undertake this themselves, limited due-diligence resources and commitment sizes (particularly for niche strategies) may restrict the number of private investments that can realistically be made.

A more complex portfolio typically demands more sophisticated risk management. A proficient multi-asset manager should therefore have access to what they believe to be superior risk and portfolio management capabilities for both public and private markets, but also for integrated public-private portfolios. We believe detailed analytics for each asset class are essential for a rigorous understanding of the sources of risk and reward across investments, which can help to identify correlations of performance, factors and alpha-seeking to emphasize diversifying strategies at the overall portfolio level, where possible. Investors selecting individual componentry across both liquid and illiquid asset classes, and attempting to integrate it all themselves, may not have access to the sophisticated risk and portfolio management tools required to stay on top of such a complex portfolio.

Moreover, multi-asset managers understand that clients tend to have their own specific objectives and constraints. A key component of building an unconstrained multi-asset portfolio is tailoring around a client's preferred areas of investment, while considering existing investments and capabilities and seeking to build a complementary and diversified portfolio. Specific objectives, such as maximizing the estimated potential for income or capital growth, reducing volatility or managing tax exposure, can be embedded into portfolio construction to further customize to an investor's unique goals. All these things can be more challenging when dealing with an atomized portfolio of several discrete elements.

Opportunistic, Relative-Value and Specialist Investing

Having latitude to invest across the asset universe also makes it easier to get a full view of relative value. That, in turn, enables an investor to take a more informed approach to opportunistic private markets investments.

A multi-asset manager has the potential to move quickly to:

- **Take advantage of short-term market dislocations.** A practical example of this would be the pricing dislocations we experienced in sovereign and corporate credit in March 2020 following the emergence of the COVID-19 pandemic. A dramatic explosion in the amount of high yield debt pricing at "distressed" levels, largely due to an acute market supply-and-demand imbalance, created an attractive opportunity to buy high-quality borrowers at large discounts. It was a huge opportunity for those with the market knowledge, credit analytics and restructuring expertise typically required to manage these assets. Dislocations like these are often very brief; many multi-asset managers can move fast and invest opportunistically, whereas creating a new, dedicated distressed debt mandate is likely to take longer than the opportunity lasts. An unconstrained multi-asset manager is more likely to have the scope to assess and take advantage of these opportunities across the full range of liquid, illiquid and semi-liquid markets.
- **Seize attractive secondary market and co-investment opportunities.** Mispricing, or the need for capital or liquidity, can create opportunities in private secondary markets and co-investments, both of which can improve the liquidity profile and cost efficiency of a private asset portfolio.
- **Participate in niche alternative markets.** There appears to be greater interest in very specialist alternative markets that are not typically included in a Strategic Asset Allocation (SAA) or Asset Liability Model (ALM). An unconstrained multi-asset manager can be given scope to capture potential opportunities in areas such as insurance-linked securities, pre-IPO equity, fintech venture capital and the equity tranches of collateralized loan obligations (CLOs).
- **Expedite the build-up of private markets exposure.** An investor that has the scope to pick up a wider range of opportunities in private markets is more likely to deploy its committed capital faster, thereby reducing the "j-curve" effect typical of traditional private markets investing, whereby uninvested commitments drag on overall performance.

Optimal Liquidity Management

Liquidity management is another key area where a multi-asset manager can potentially add value when managing a public-private portfolio. Traditional private markets investing requires cashflow management both on the build-up and exit of an investment. Having a sophisticated and efficient liquidity management strategy in place can potentially enhance the overall performance outlook for a portfolio. Liquidity portfolios can be carefully managed in line with an investor's desired appetite for risk. The challenge is to strike a balance; keeping risk-free assets earmarked to meet liquidity requirements will likely drag on performance, but being forced into a "fire sale" of riskier assets to fund private markets capital calls in a time of volatility is also a big risk. The reinvestment and disinvestment of these cashflows can become an operational and administrative burden on investors, too.

A multi-asset manager running an unconstrained portfolio can manage liquidity at the whole-portfolio level, focusing on managing the downside while utilizing its specialist capabilities in public markets to access uncorrelated, diversified liquid alternatives for the committed-capital portfolio. Furthermore, cashflows from a range of portfolio investments can be recycled to meet capital calls with no burden on the investor. Managers that have developed innovative ways to access private markets via semi-liquid structures—by making full use of secondaries, co-investments and income-generating private credit investments, for example—may be able to use these to optimize the cash flow profile of the broader private markets allocation. Similarly, "evergreen funds" are growing in popularity and can be combined with traditional fund commitments to seek to improve the overall liquidity profile of a public-private portfolio.[1]

A Governance-Light Solution & Resource Extension

For investors, integrating individual public and private investments into one portfolio is a governance-intensive task, from initial due diligence and manager selection to portfolio construction through to ongoing monitoring and reporting. We believe private markets investing requires a deeply resourced portfolio management team with a wide skill set, particularly given the size and diversity of the universe of private markets managers.

Furthermore, the ongoing monitoring and management of liquidity becomes much more involved as more private asset allocations are added. Maximising portfolio efficiency often requires more advanced risk and cashflow management capabilities: specialist modelling across both public and private assets is needed to capture the exposures of an integrated portfolio at a given point in time and as the net asset values (NAV) of private markets investments evolve.

Additionally, integrating reporting across public and private investments can be challenging when individual components report using different performance metrics—such as internal rate of return (IRR) versus total returns. Where a multi-asset manager has greater access to and control over the underlying data, it can build cohesive performance reports at the whole-portfolio level.

Investors with limited in-house resources may benefit from outsourcing some of the governance burden of portfolio management to a multi-asset manager with expertise in both public and private markets that can tailor a governance model to the investor's appetite for involvement—up to assuming portfolio governance responsibility in its entirety. Using a multi-asset manager to any degree can benefit investors via information sharing and knowledge transfer. Part of partnering with investors is acting as an extension of the investor's resources, sharing the latest ideas, research and expertise and helping in the development of best practices.

Fee Optimisation

Multi-asset managers can work to optimise the costs of running an unconstrained portfolio by adjusting allocations to make it as fee-efficient as possible. Analysing consistency of manager alpha, market beta and factor exposures, and the correlations between them, can help identify demonstratable alpha versus market and factor exposures: the findings can inform asset allocation decisions that can help to optimize the portfolio's fee-to-alpha ratio.

Furthermore, we believe multi-asset managers have the advantage of access to some of the best economics on both public and private markets investments on behalf of investors. This might be through access to fee-efficient implementation routes, such as direct co-investments, seed investments or first-closer investments; or through the ability to aggregate commitments across client accounts, to reach a more material size than many investors can achieve individually. The public side must also be priced competitively and in such a way that the blended fee reflects the overall allocations and components. After all, we believe a net-of-fees performance evaluation gives a more complete picture of the investment results experienced by the client.

[1] For a fuller discussion on liquidity management for private markets programs, see Joe McDonnell and Rebekah McMillan, "Integrated Liquidity Management for Private Markets Programs" at https://www.nb.com/en/link?type=article&name=whitepaper-integrated-liquidity-management-for-private-markets-programs.

Conclusion

As the market environment becomes more challenging, we believe we are witnessing an end to three decades of "easy beta." We think active management across as broad a universe as possible will become crucial for mitigating against volatility and market drawdowns. As part of that shift to more active management, we believe the return-profile, diversification and portfolio-efficiency benefits of adding private markets to multi-asset portfolios are readily apparent. But as well as asking *why* one should consider investing in private alongside public markets, we think it is just as important to ask *how* to manage those investments together.

We believe a multi-asset manager can work alongside clients to create a whole or complementary solution that helps navigate the market challenges, develop best practices and ultimately seek a more efficient, opportunistic and cost-effective portfolio with minimal additional governance burden. The initial due diligence demands of selecting a suitable manager for this role are considerable, but we believe they are necessary: few have the specialist capabilities and expertise in both public and private markets necessary to provide truly customized, compelling public-private portfolios.

Index Definitions

The **Bloomberg Global Aggregate Bond Index** is a broad-base, market capitalization-weighted bond market index representing intermediate-term investment grade bonds traded worldwide.

The **MSCI All Country World Index** is a market value-weighted index of more than 2,700 stocks from 23 developed and 24 emerging countries.

The **Cambridge Associates Global Private Equity Index** tracks the pooled horizon return, net of fees, expenses and carried interest, of 1,762 U.S. private equity funds (buyout, growth equity, private equity energy and subordinated capital funds), including fully liquidated partnerships, formed between 1986 and 2021.

The **Cambridge Associates Global Private Debt Index** tracks the pooled horizon return, net of fees, expenses and carried interest, of global private debt funds, including fully liquidated partnerships, formed between 1986 and 2017.

The **Cambridge Associates Global Real Estate Index** tracks the pooled horizon return, net of fees, expenses and carried interest, of 1,260 global private real estate funds, including fully liquidated partnerships, formed between 1986 and 2017.

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