APRIL 2023

The Role of Private Assets in Strategic Asset Allocation: a Macro Perspective

The appropriate weight of private assets in portfolios is arguably the key question for strategic asset allocation today. These investments were the fastest-growing share of many portfolios for the past decade: Will the abrupt change in investment regime and greater need for liquidity halt that increase?

We argue that all the forces that have ushered in higher private allocations in recent decades are still in place, if anything they've strengthened. Allocations must still grow as investors seek higher inflation-protected returns and diversification. There are, however, new challenges in the form of greater liquidity needs and near-term overweight positions for some investors.

We also discuss the allocation within private markets and suggest that the marginal flow of capital, from a strategic perspective, should be directed to areas other than private equity, such as private debt, natural resources and infrastructure investments.

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Should asset owners increase their exposure to private assets? This is arguably the most important strategic allocation question for 2023. Exposure has risen for many types of investors in recent years, and has been one of the primary dynamics of change in asset allocation. The rationale was rooted in dismally low return expectations and a need for diversification. That case held in an era when liquidity was plentiful and expectations for bond returns were firmly negative in real terms.

Does the case still hold in the current environment? To put it more bluntly, after the painful declines in public bond and equity markets since early 2022, do investors still need private assets in the same way? We'll make the case that private asset allocations still need to rise in general—but the case has become more finely balanced.

We see the role of private assets in asset allocation as a secular shift that has further to go—we stress that this is a strategic allocation statement distinct from a tactical view. Private assets play both return and diversification roles, and the case for a greater supply of private capital is driven by the shrinking amount of public equity capital and a retrenchment among traditional lenders. The declining share of credit provided by traditional lenders (banks) has been a multi-year process, but it's still very much a current issue. In the wake of the Silicon Valley Bank demise and recent banking turmoil, more regulation is likely, which will likely further limit credit creation by banks. The longer-term opportunity in private assets is here to stay, notwithstanding the considerations of specific investors, such as liquidity and the potential for near-term writedowns heading into a period of slower growth.

When considering private allocations, a key question is: What is one paid to hold an illiquid private asset? The traditional answer is an illiquidity premium, spurring debate on whether that's still true across sub-categories of private assets today. However, there are other potential return sources, such as the role of legal structure (including legal documentation and financial covenants) and control (a sole investor or group of like-minded investors) in contributing to an idiosyncratic return stream and the ability to access segments of the economy not well represented in public markets.

Why has the allocation to private markets surged in the last decade? On the demand side, it was a response to low return expectations across asset classes and a need for diversifiers under the auspices of plentiful liquidity from central banks. There was a supply side force, too, with a decline in the stock of public equity (higher prices but fewer shares) and banks' retreat from providing credit, reinforced by borrowers' growing appreciation of the speed and flexibility of private-market execution. The supply argument is augmented by the recognition that, in many cases, there's more flexibility in loan structuring with private capital. Most of these forces remain in place today.

We can distil the issue for asset owners into two core questions that we'll seek to answer:

1) What weight should private assets have in an overall asset allocation?

2) Where should marginal flows go among different categories of private assets?

The answers clearly depend on an individual investor's liability, time horizon, liquidity needs and governance structure, though we think there's still a broader case for many investors to increase exposure. However, the debate has become much more nuanced, given the transformation in the liquidity environment and the abrupt downturn in public market prices during 2022.

Allocations have generally risen, given the smaller denominator with the public market selloff, though in our view this is a short-term issue. We don't want to belittle its impact on asset allocator's thinking over the next 12 months, but for long-term investors, we would argue that any problem would be related to governance rules; the liquidity question is stickier, as we'll explain. In terms of marginal flows into private assets, there's a case to favor areas outside private equity, which took in the lion's share of capital over the last decade. This case is particularly relevant as other private asset classes, such as private credit, mature. And as the range of private assets expands, it could fill gaps in available return streams.

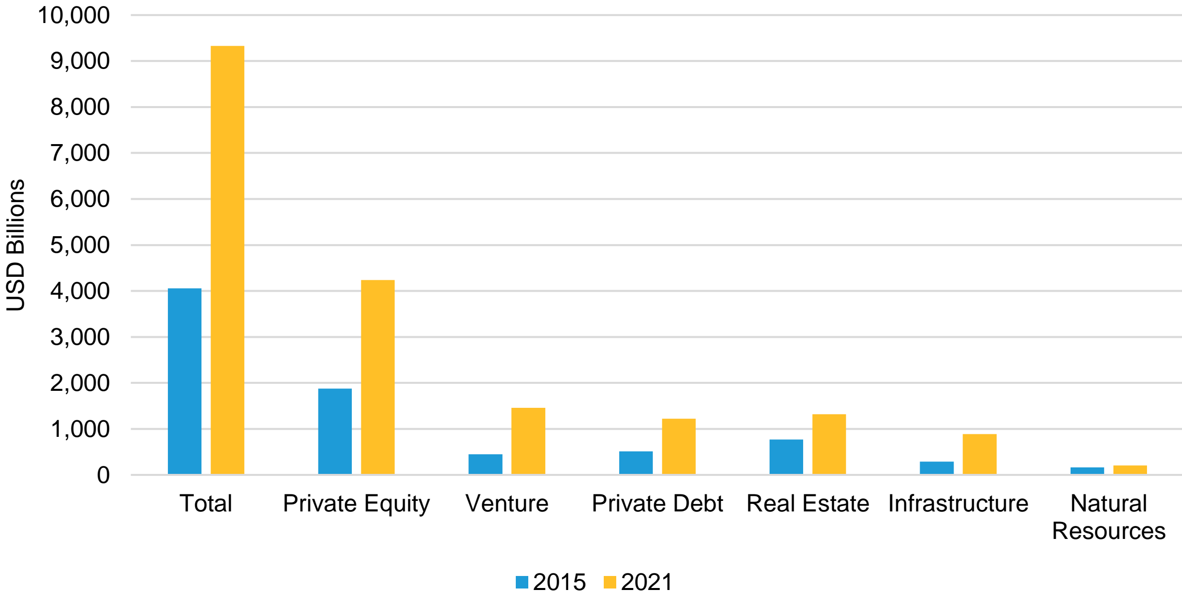
Some investors may have tactical considerations. Many US state plans, for example, have recently reported an overweight in private equity versus target,[1] which says more about the 2022 drawdown in public equity and fixed income than it does about private equity itself. We think this situation may well affect the pace of allocation decisions in the near-term, but the time horizons affecting allocations to private assets are ultimately longer. There are more serious considerations affecting this allocation decision, particularly the ongoing need for more liquidity, which we'll address below. Overall, assets under management in private markets have grown tremendously over the last 20 years. According to Preqin, they rose from less than USD1 trillion in the early 2000s to more than USD9.3 trillion in the second half of 2021. Growth was particularly strong in the five-year stretch from 2015 to 2021, which saw an annualized increase of nearly 15%. Venture capital was the fastest-growing sector at 22% (Display 1), followed by private infrastructure at 20.5% and private debt at 15.7%.

[1] See Four Strategic Allocation Issues for Asset Owners in 2023

By way of comparison, we can express this as a percentage of public market capitalization as a first order approximation of its shift in asset owner portfolio weight. On that basis the overall AUM of private markets grew from 8% of global market cap in 2015 to nearly 11% in 2021.

DISPLAY 1: PRIVATE ASSETS HAVE SEEN TREMENDOUS GROWTH

AUM GROWTH OF PRIVATE MARKET SEGMENTS



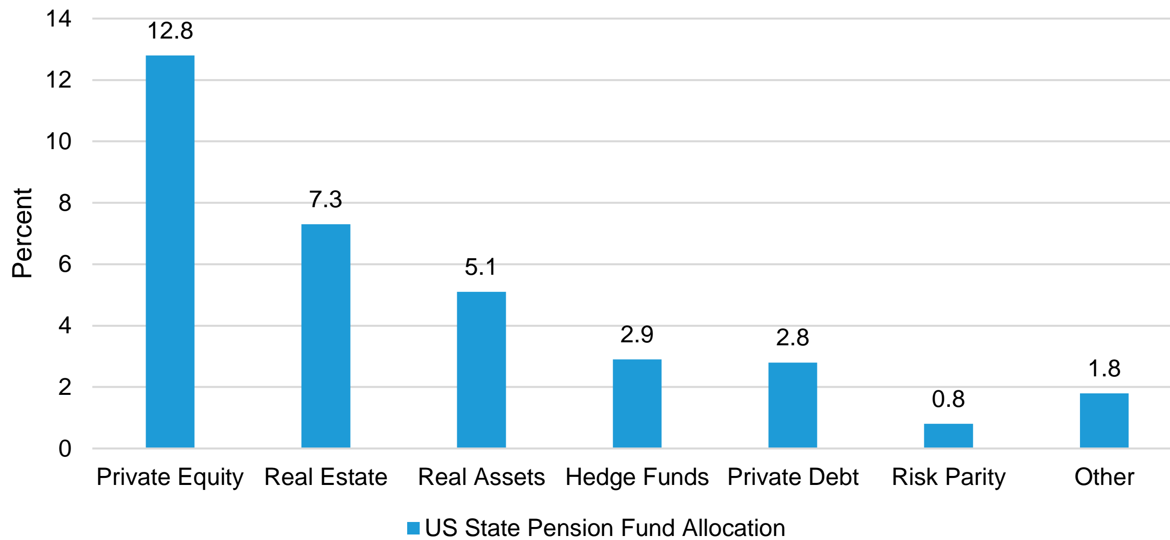
Historical analysis and current estimates do not guarantee future results.

As of February 17, 2023

Source: Preqin and AB

Among US state pension funds, private equity is the largest current allocation at nearly 13% (*Display 2*), followed by private real estate at 7.3%. The share of private debt is relatively small at 2.8%, but has been growing rapidly in recent years, with much recent attention from investors.

DISPLAY 2: US PENSION FUND PRIVATE ALLOCATIONS VARY ACROSS SUBCATEGORIES



Historical analysis and current estimates do not guarantee future results.

The chart shows asset-weighted allocation for US State Pension Funds.

As of June 30, 2021

Source: Cliffwater and AB

Assessing the macro backdrop

Investors can't determine the role of private assets in asset allocation in isolation—the macro backdrop is a key driver. Our view is that the post-pandemic world presents investor with a new macro equilibrium that demands a response. For many asset owners, the awkward fact is the likelihood of a significantly lower real Sharpe ratio on their assets than was achievable over the last 40 years. For more detail on this point, see our recent black book. The different moving parts to this conclusion are:

- The likelihood that inflation finds a strategic equilibrium level above the pre-pandemic level, raising the bar on the ability to maintain purchasing power (a function of deglobalization, a shrinking global labor force and the socio-political implications of ESG).
- A lower growth outlook compared with the norms of recent decades, with the additional effect of declining corporate margins (again, with deglobalization and demographics at work)
- The case for a higher level of macro volatility from greater government involvement in the economy, the transition from monetary to fiscal policy, the higher level of debt/gross domestic product (GDP), and the direct and indirect effects of climate change
- Bonds are less likely to be as effective a diversifier; 2022 should be a wake-up call to investors on this point.
- A greater need for active returns as returns from passive exposure to asset-class "betas" falls. An allocation to idiosyncratic alpha should be an explicit part of strategic asset allocation.

We're at pains to point out that this isn't a bearish situation; it still leads to positive returns on most asset classes, but the building blocks of asset allocation and portfolio design still need to be revised significantly in this world view, as we detailed in our recent black book.

The supply case: Are private assets filling a gap for investors?

One force driving higher investor allocations to private assets is the shift in the share of capital raising across the economy. There are two specific issues: the shrinking aggregate size of markets for public securities or traditional capital sources and the exposure to specific areas of the economy that are underrepresented in public markets. The supply argument is augmented by borrowers' recognition that, in many cases, private capital offers more structural flexibility, speed and execution certainty.

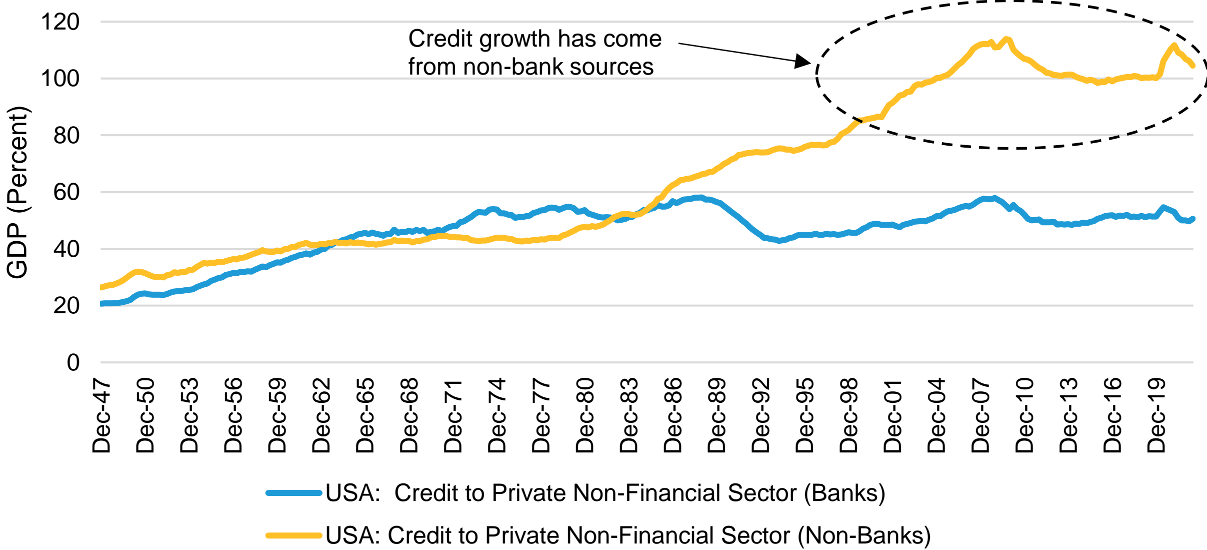
Private credit has grown in part because traditional lenders have stepped away from providing credit. In the process, private credit has evolved from a high-risk niche asset class (such as mezzanine lending) to a collection of more diverse return streams across the risk-return spectrum that cover areas including direct lending, real estate, green infrastructure and hard assets.

The retrenchment of traditional credit providers (banks) has been a multi-year phenomenon but should be very much at the forefront of concerns in 2023, given the banking-sector turmoil in the wake of events such as Silicon Valley Bank and Credit Suisse. This episode will likely lead to more regulation and a further brake on banks' ability to extend credit. Notwithstanding the cyclical impact of a slower-growth period on credit demand, we're likely to see a further structural shift in favor of non-traditional credit sources.

In the US, the share of credit provided by non banks overtook credit provided by banks in the mid-1980s (*Display 3*); since then, all net credit growth (as a share of GDP) has come from the non-bank sector.

DISPLAY 3: CREDIT GROWTH HAS COME FROM NON-BANK SOURCES

OVERALL PROVISION OF CREDIT TO THE PRIVATE SECTOR IN THE US



Historical analysis and current estimates do not guarantee future results.

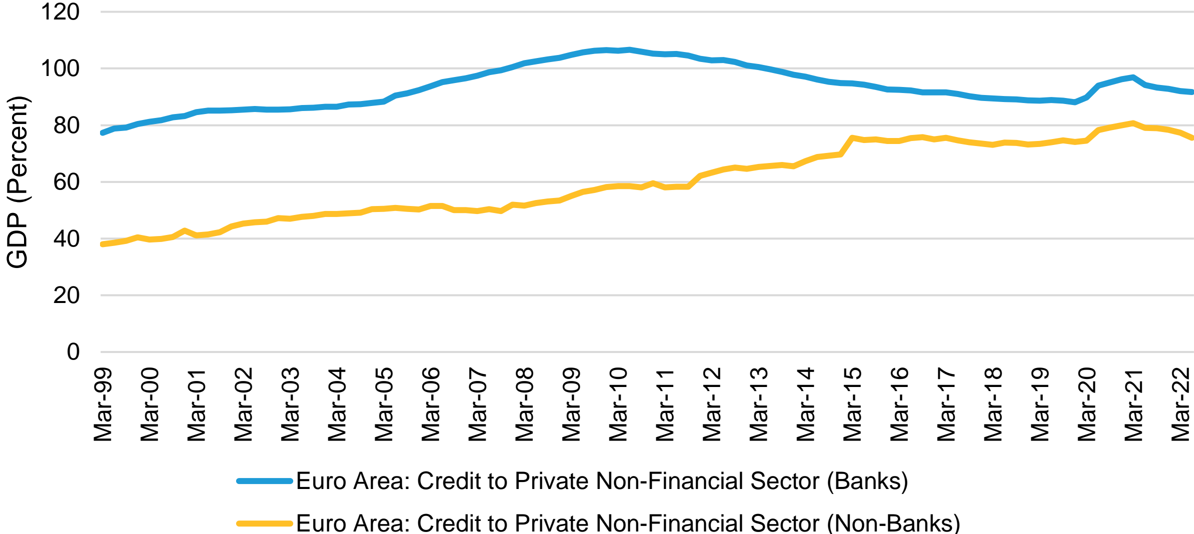
As of June 30, 2022

Source: BIS and AB

The euro area has seen almost no net credit growth since the European debt crisis. Nevertheless, non-bank providers have taken market share as banks have retrenched (*Display 4*).

DISPLAY 4: EUROPEAN NON-BANK PROVIDERS HAVE TAKEN MARKET SHARE

OVERALL PROVISION OF CREDIT TO THE PRIVATE SECTOR IN THE EURO AREA



Historical analysis and current estimates do not guarantee future results.

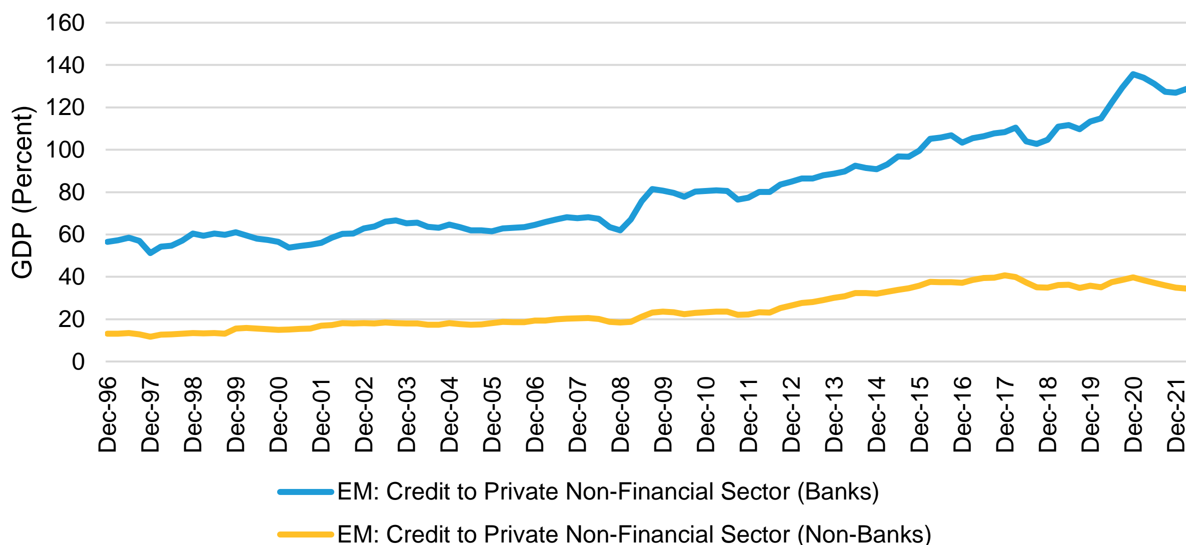
As of June 30, 2022

Source: BIS and AB

Finally, emerging market (EM) banks still provide a very large share of credit to the private sector, and there's little evidence of the non-bank sector gaining market share—even during the strong credit expansion over the last decade. This is understandable in the context of higher risk and a need for larger teams to develop such a market, but if we assume that EM starts to follow the pattern in developed markets, there's significant growth of private credit provision to come.

DISPLAY 5: EM BANKS STILL ACCOUNT FOR A LARGE SHARE OF CREDIT PROVISION

OVERALL PROVISION OF CREDIT TO THE PRIVATE SECTOR IN THE EMERGING MARKETS



Historical analysis and current estimates do not guarantee future results.

As of June 30, 2022

Source: BIS and AB

In a similar vein, the increased allocation to private assets is, *inter alia*, a natural response from asset owners to a structural decline in the stock of public equity in developed markets. The total market cap of the US stock market and developed world has increased, but only because of rising prices. Buybacks, on the other hand, have exceeded issuance, causing the stock of shares in circulation to decline. Corporations have been the largest buyers over the last decade, with the current run rate of buybacks at a record level.

Even assuming that buybacks slow as economic growth slows, the combination of continued buybacks and structurally lower issuance lead us to forecast a continued decline in the stock of developed market equity over the next decade. It would require a huge shift in regulation and the macro landscape to alter this path—for example, a change that would make buybacks less attractive and issuance of public equity easier while de-linking management pay from per-share variables. A shift on this scale doesn't seem likely.

The number of shares in the MSCI All-Country World Index have increased slightly due to net positive issuance in EM, but even that broader index has seen a marked lack of new supply compared with previous decades (*Display 6*). Higher net supply of EM equities in recent years has been mainly driven by changes in the inclusion factor for Chinese equities in global indices, a process we regard as somewhat of an illusion, or at the very least highly discretionary on the part of companies that manage index construction.

Given this landscape, and with all else equal, an asset owner wanting to earn equity or credit premia should have a larger allocation to private markets than was the case 20 years ago.

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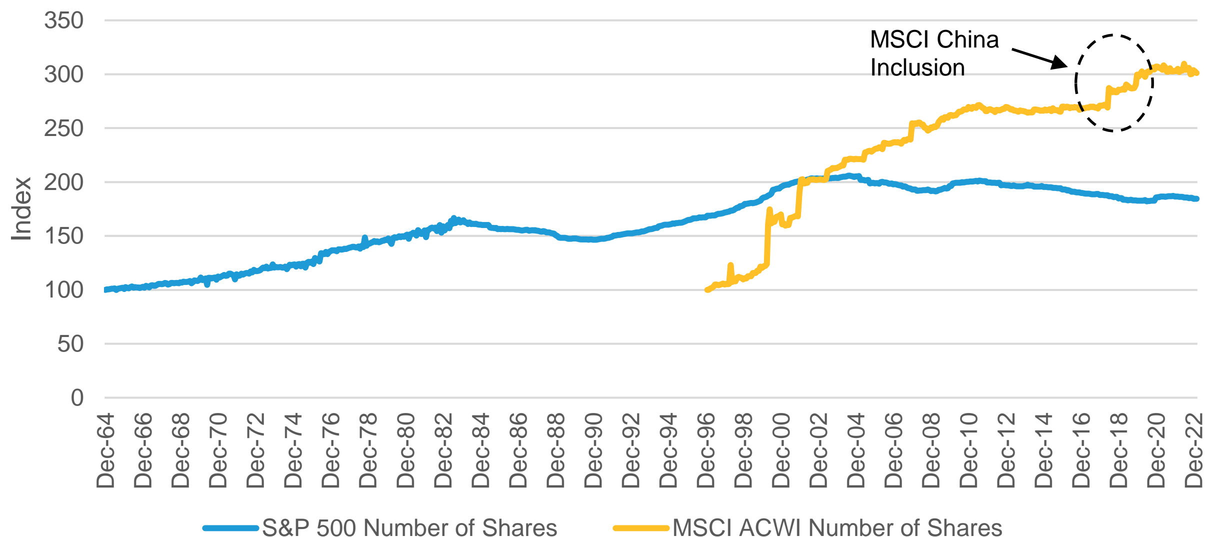
DISPLAY 6: STOCK OF SHARES SHRINKS IN DEVELOPED MARKETS WHILE RISING IN EM FROM AD HOC CHINA INDEX INCLUSION FACTORS



Historical analysis and current estimates do not guarantee future results.

The circled area shows the impact of the change in the MSCI inclusion factor for China equities.
As of January 31, 2023
Source: Bloomberg, MSCI, Thomson Reuters Datastream and AB

This net-supply argument driving demand for private equity and credit doesn't apply to government securities, which have a super-abundance of supply.[2] This situation is one element of our more negative view on including government bonds in portfolios that need to preserve purchasing power far into the future.

The broader context is that while financial assets have outperformed real assets since 1980, there are signs this may be reversing (*Display 7*). Since a peak in mid-2020, the relative outperformance of financial assets (represented by US equities and 10-year government bonds), over financial assets (represented by US residential real estate and a broad commodities index), has experienced a big decline, with a peak-to-trough drawdown of 38%.

Our strategic view is for higher inflation and lower financial-asset returns than in recent decades, which changes the calculus for investors—depending on their liabilities. In recent decades, regardless of whether liabilities were in terms of nominal targets or real targets, it made sense to meet them with financial assets, not real assets. However, our macro view implies that investors with real liabilities—and thus a need to preserve purchasing power—may now wish to rebalance this allocation. So, there's a need for investors to, in a sense, "buy the real economy" as part of a strategic inflation hedge. Owning return streams that are large in the real economy but under-represented in public markets therefore becomes more urgent.

[2] See our recent discussion of why demand will exceed supply for equities in coming years, but the opposite is the case for sovereign bonds

DISPLAY 7: FINANCIAL VS. REAL ASSET RETURNS: A FURTHER ADJUSTMENT TO COME

Historical analysis and current estimates do not guarantee future results.

Financial assets are US Equities and US 10 year government bonds. Real Assets are US Real Estate and Bloomberg Commodities indices.
As of January 31, 2023
Source: Bloomberg, Global Financial Data, Robert Shiller's database, Thomson Reuters Datastream and AB

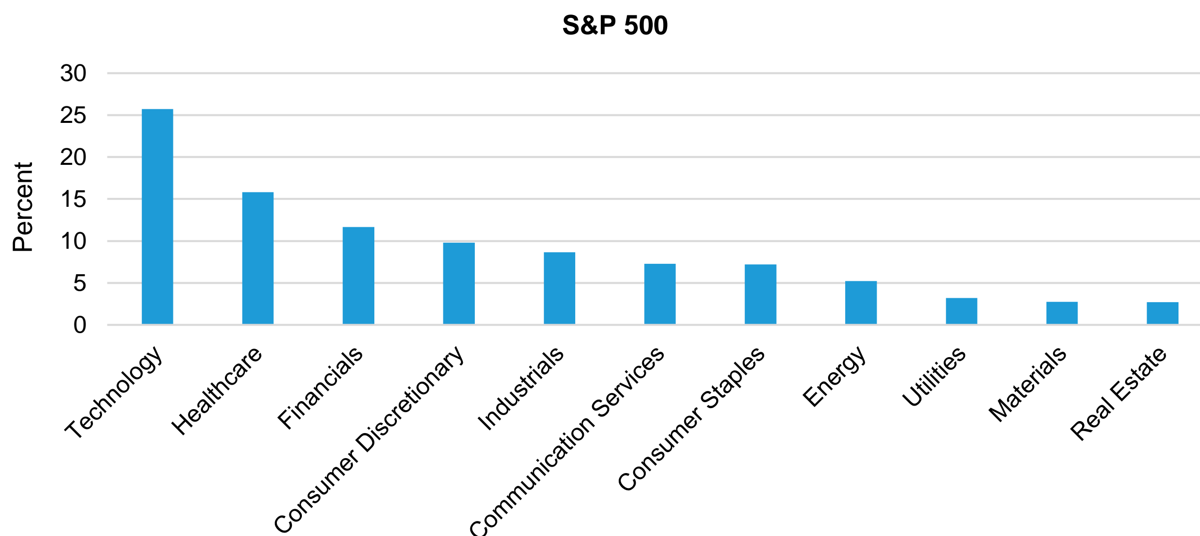
Can private markets help craft a portfolio that's closer to the real economy?

For investors seeking real-economy exposure within a strategic inflation hedge, there's a question of whether private market exposure can help fill some of the gaps left by public market exposures.

We can see these gaps, using the US as an example, by comparing the weights of sectors in the public equity market with those in the economy, as measured by the share of GDP. For the economy, we exclude the government sector, because investors can't easily replicate it; in a modern economy, they can't really gain exposure to tax collection, despite it being possible in various historical episodes.

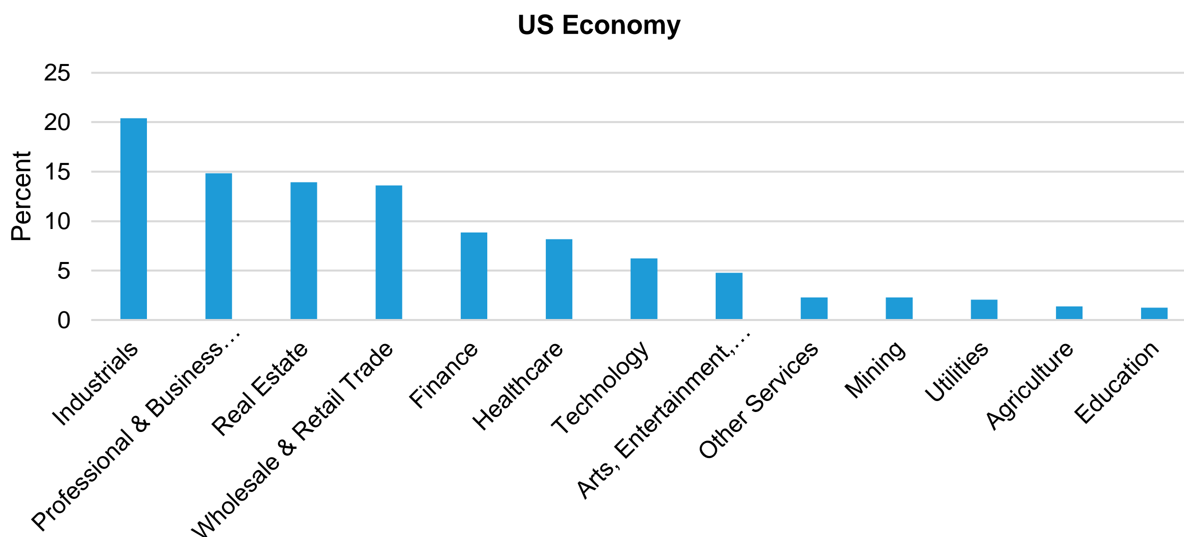
Comparing these sector distributions reveals that the listed equity market is significantly "overweight" technology and healthcare (*Display 8*) and, by contrast, very "underweight" in infrastructure, real estate and agriculture. Infrastructure broadly falls under industrials and utilities. A wider definition of industrials, including manufacturing, construction and transportation, is the biggest weight in the real US economy (*Display 9*) but only a middle weight in the public market. Moreover, real estate is the third-largest sector in the US economy but the smallest in the S&P 500. Agriculture is a smaller but noticeable weight in the real economy but present only indirectly—and in very small size—in public markets via the agriculture equipment and fertilizer sector.

DISPLAY 8: **SECTOR WEIGHT IN LISTED US PUBLIC EQUITIES**



Historical analysis and current estimates do not guarantee future results.
As of February 24, 2023
Source: S&P Global, Thomson Reuters Datastream and AB

DISPLAY 9: SECTOR WEIGHTS IN THE REAL US ECONOMY



Historical analysis and current estimates do not guarantee future results.
As of February 24, 2023
Source: S&P Global, Thomson Reuters Datastream and AB

More broadly, only a minority of US companies with revenues over USD100M are publicly listed[3] , pointing to the need for other exposures aside from public markets. Seen in this way, the role of private assets in portfolios is not only about earning an

[3]By number of companies, not by size. See: https://www.bain.com/globalassets/noindex/2023/bain_report_global-private-equity-report-2023.pdf

illiquidity premium and finding sources of diversification but also about rebalancing the distribution of portfolios in an effort to get closer to the real economy.

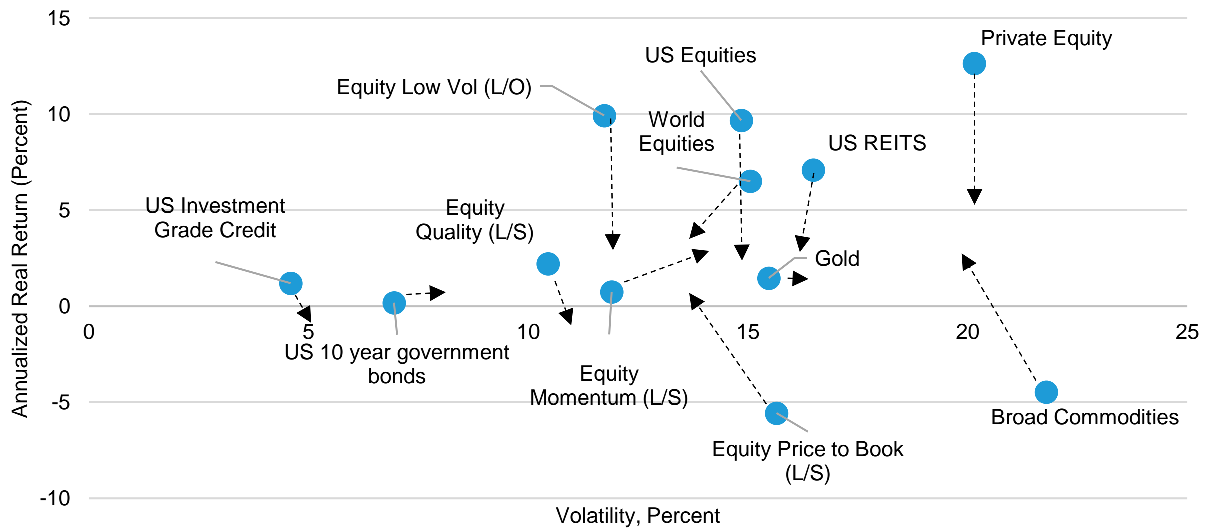
This effort is a consideration when we consider which private assets are most relevant for investors' portfolios. Historically, private equity managers have explicitly eschewed lower-growth sectors, meaning that the footprint of private equity is also overweight tech. While this may help portfolios in other ways (for example, the wide dispersion of returns implies a fund-selection alpha), it doesn't help investors get closer to the real economy. Areas such as infrastructure, real estate and natural resources assets (including farmland) are more helpful in this regard.

There's a broader point here, too, about the nature of investing. We've long argued that there's really no such thing as passive investing, at least not as it's traditionally understood. The true benchmark for many investors is, or should be, inflation. After all, the point of most investing is to meet liabilities set in the real economy (such as the cost of retirement). In this context, an investment in an index such as the S&P500 is not passive—instead, it's a highly active decision. By including sectors not represented in public indices, private markets can help close this gap.

The Demand Case: Private Assets as a Response to Lower Sharpe Ratios

The investor demand argument for private assets could be even stronger than the supply argument. The root cause is the prospect of investors earning lower real Sharpe ratios on their investments over the next decade than over the last 12 years (*Display 10*). Three forces are at work: 1) lower expected nominal returns; 2) higher inflation and; 3) diversification becoming harder to achieve. We recently wrote a black book on this topic, so we won't repeat the arguments here, but this scenario suggests an ongoing need to change strategic asset allocation.

DISPLAY 10: EXPECT LOWER RETURN/RISK ACROSS ASSET CLASSES (FROM HIGHER INFLATION AND LOWER NOMINAL RETURN)



Historical analysis and current estimates do not guarantee future results.

Note: The dots represent real returns and volatility for January 2010 to December 2022 period for the major return streams that investors can buy. The arrows represent the AB Institutional Solutions team's forecasts for the next 5–10 years. Private Equity return data is the US Private Equity Index from Cambridge Associates, compiled from 1,562 funds, including fully liquidated partnerships, formed between 1986 and 2019. All returns are net of fees, expenses, and carried interest. Data are provided at no cost to managers. Private Equity volatility is estimated from MSCI US Small Cap Value index with 15% leverage

As of March 17, 2023

Source: Cambridge Associates, FactSet, FRED, Ken French Data Library, MSCI, Thomson Reuters Datastream and AB

One of the big shocks of 2022 was the comprehensive failure of bonds to diversify equity risk. We think investors need to get used to this, and it implies a big shift in thinking and portfolio design.[4] Sources of diversification will become more important, and the trade-off between real income and diversification will become a more prominent preoccupation among investors.

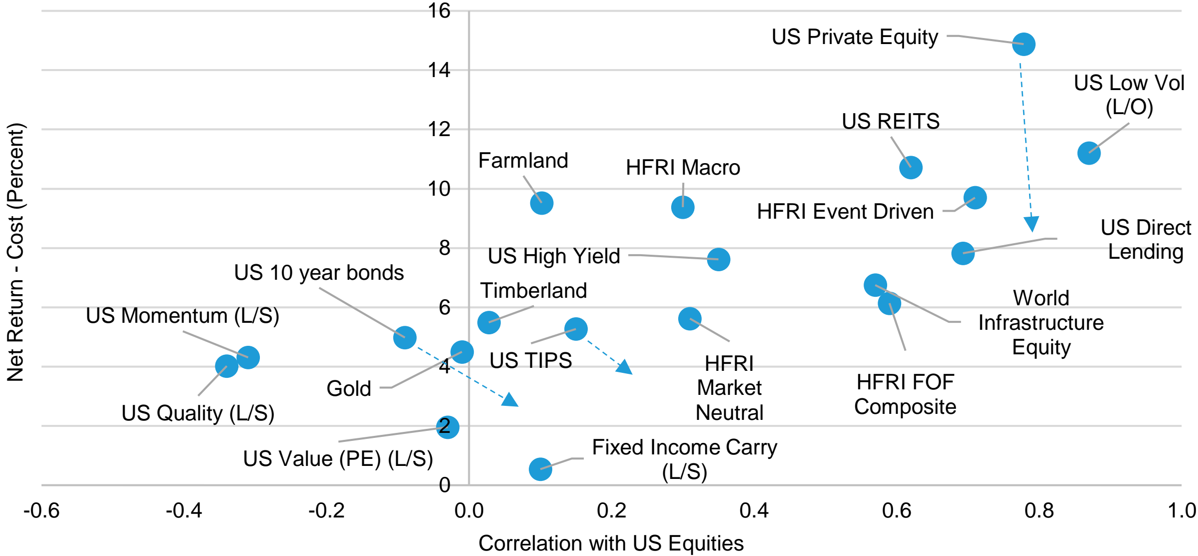
[4] See the Chapter 4 What Happens When Diversification Disappears in our black book, *A Painful Epiphany*

In a world of moderately higher inflation, equities are an important portfolio anchor, given their size as a liquid quasi-real asset. The question is: What other assets can be added alongside equities to complement them? Private assets can play an important role in offering diversification. However, there's a need to distinguish between faux diversification from stale prices and real diversification from genuinely differentiated return streams (such as a very differentiated asset that one can't otherwise get exposure to in public form, the benefit of control or better downside protection).

In *Display 11*, we show the trade-off of net return (after fees) and correlation to equities for a broad range of return streams. The dots show data from the past 30 years; the dashed arrows show where we expect a few key return streams to move over the next decade. It's apparent that different kinds of return streams occupy different areas of this space. Long/short factor strategies, on the left side, offer negative correlation to equities. The middle of the chart includes more traditional diversifiers: gold, nominal bonds and inflation-protected bonds. To the right are a series of private assets, both real and financial.

Direct lending to corporations (shown in the display) is only one part of the private-debt universe. Given the corporate nature of the underlying business, there's a good case to suggest that other forms of private credit, such as real estate, infrastructure and specialty finance, have a lower correlation to equity markets, and therefore should be to the left of the direct-lending point. However, the lack of long-run data prevents us from empirically demonstrating that case.

DISPLAY 11: ASSESSING THE RETURN/DIVERSIFICATION TRADE-OFF



Historical analysis and current estimates do not guarantee future results.

Note: The chart uses monthly data from Jan 1990 (or longest available history) to Dec 2022. Private Equity, Direct Lending, Farmland and Timberland series are quarterly. Direct lending is corporate. We assume 10bps fee for US 10 -year bonds, Gold, REITS, TIPS and High Yield bonds. We assume 20 bps fee for Long Only factors and 50 bps fee for Long/Short factors. For Timberland and Farmland we assume 150bps fee. For Direct Lending we assume 150bps fee.
As of March 17, 2023
Source: Bloomberg, Cambridge Associates, Cliffwater, Global Financial data, HFRI, NCREIF, Thomson Reuters Datastream and AB

The Pros and Cons of Private Assets in Strategic Asset Allocation

We can bring all this together to outline the overall pros and cons of including private assets in investor portfolios today. In our view, all the forces that have driven allocations to private markets over the last decade remain in place—if anything, they've strengthened. However, there are also new constraints, so the strategic asset allocation controversy is about the interaction of these forces and what it means at the macro level as well as for individual investors (*Display 13*).

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DISPLAY 12: CURRENT PROS AND CONS OF PRIVATE ASSETS

A need for more private assets

Demand (from investors)

- Prospect of lower nominal return on public markets
- Need for diversification
- Need for inflation protection
- Exposure to sectors not represented in public markets
- Need for active return streams

Supply

- Dearth of young high growth companies coming to market
- Buybacks leading to shrinking stock of public equity
- Retrenchment of traditional providers of credit
- Borrowers recognizing greater flexibility of private capital

Emerging limits on private market allocation

- Denominator effect. Many funds are now overweight private assets vs target
- Liquidity is a greater concern:
  - QE to QT
  - Asset owner portfolios are more illiquid
  - More fragile liquidity in public markets
- Fees – this is now the lion share of many fee budgets

Historical analysis and current estimates do not guarantee future results.
Source: AB

We set out the supply and demand forces in the previous section. Private assets don't have a unique claim on inflation protection, of course, but an important subset of them can help with that objective, and they become all the more important if there's a broader claim that assets can offer diversification versus public markets. We think these two forces are poised to become more important in the minds of asset allocators.

The benefit of control has long been an important claim for private assets. The ability to prove this—or not—at a single asset or fund level isn't part of our discussion here. Instead, we make the macro case that there should be greater appetite for an active approach in a world where the returns from long-only passive betas is lower, markets are less trended and the business cycle has reasserted itself. This case leads to a general view that active return streams, in general, should become a larger part of the end client's return stream.

As active management becomes a larger component of an overall portfolio's return/risk, private assets naturally play an important role (in private equity, for example, via the ability to determine corporate policy and in private credit via aspects such as the potential to manage through a potential default cycle). It would be a mistake to assume that private alternatives are the only alpha source in a portfolio. Instead, we see them as offering one input alongside other categories such as active portfolios in traditional asset classes, contributing to an overall allocation to the potential for generating idiosyncratic returns.

Set against these strengthened claims in favor of private assets, the case against them has also evolved. The most significant element is what we believe will be a sustained need for greater liquidity. There are three key reasons for this need:

- The reduction in macro liquidity implicit in the (attempted) switch from quantitative easing to quantitative tightening
- Asset owners' shift to more illiquid portfolios
- Recognition that the available liquidity in public markets is more fragile

All these reasons point to liquidity being a greater concern for investors. It also suggests, at the margin, that given two similar return streams investors should put increased weight on the more liquid one. At one level, this situation will likely slow the flow into private assets for some investors. However, it will also prompt a more nuanced examination of the potential that some private assets may even help with very specific liquidity needs (short-duration cash-generating assets, for example). Private assets with cash flows that meet investors' liquidity needs can also help, since they don't require finding a market exit to realize a cash flow.

There's also a more tactical concern about the impact of a slower-growth period and whether there needs to be a mark-to-market that could change the case for private assets. Investors are alive to the advantages of floating-rate private credit, for example, as part of an inflation hedge. The concern we hear in client meetings is whether this also implies more distress on the part of borrowers. This note is more strategic in nature rather than tactical, but addressing this point is nevertheless important. Our base

case is for a period of slower growth rather than a deep recession, but even a period of slower growth and higher rates, if it lasts for a while, will likely lead to more defaults. However, private lenders have some potential advantages in their ability to engage, such as with private equity owners, and potentially restructure.

The bottom line is that the environment in recent years, which featured low expected returns on traditional financial assets and plentiful liquidity, was uniquely advantageous for private assets. The concern we hear expressed is whether an increase in expected returns from public markets and reduced liquidity undermines this advantage. The point of unpacking these arguments here is to make the case that, despite a slight uptick over the last year, expected returns are still low in a longer-term context. Liquidity needs are always specific to a given investor, but regardless of these distinctions, we suggest that the topic is higher up on the list of concerns now than in recent years. Thus, liquidity becomes part of a more nuanced balance at the individual investor level, rather than something that removes the case for private assets.

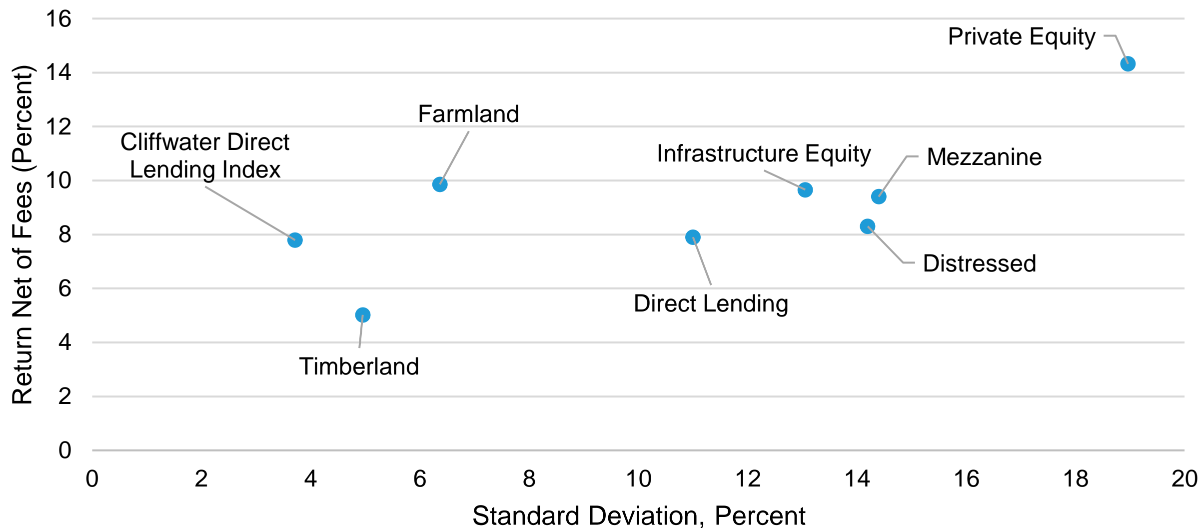
Another way of phrasing this situation is that investors have been happy to move down the quality spectrum in recent years as they searched for returns—or at least they've had little choice. There might be concern that the shift to a lower-quality mix along with accepting lower liquidity builds up a problem for the system overall and for individual investors. We'll cover this in more detail below in the context of credit quality. From a macro perspective, it's possible to sketch out a bearish case for assets and growth in the economy in general, but we think it would be wrong to make that a central case—it would require a more specific trigger. Our central case is for positive real growth.

The role of individual private asset classes within overall allocation

If many investors still need to grow their allocation to private assets, which specific ones should they buy? In *Display 13*, we show the historical net-of-fee nominal return and volatility for private-asset categories using data from January 1996 through December 2020. Returns for direct lending, mezzanine debt, distressed debt, venture debt and special situations are from Boni & Manigart (2022), who use data provided by Preqin. Their series shows the median net-of-fee internal rate of return (IRR) for the different sub-categories of private-debt funds. The Cliffwater Direct Lending Index (CDLI) represents an asset-weighted index of 12,000 middle-market loans, with data starting from September 2004. We assumed a 150 basis point fee, which reflects a 75 basis point management fee and a 10% performance fee.

For private equity returns, we used the Cambridge Associates US Private Equity Benchmark. To avoid issues of overly smooth performance of private equity assets due to a lack of marking-to-market, we used the volatility of a public-market equivalent index comprising MSCI US Small Cap Value returns with 15% leverage. For infrastructure, we also used a public equivalent index—Dow Jones Brookfield ex-MLP Global Infrastructure. For farmland and timberland, we used the NCREIF performance indices and assumed a 1.5% management fee. Volatility is the other notable difference between the Cliffwater Direct Lending Index and the Preqin series. This could be accounted for by the fact that loan values for the CDLI index are established based on a quarterly fair-value assessment of loan worth, making the return profile much smoother. Meanwhile, the Preqin series is calculated as IRR from net of fees cashflow data to LPs.

DISPLAY 13: HISTORIC NET-OF-FEE RETURN AND RISK FOR SELECT PRIVATE ASSET CATEGORIES



Historical analysis and current estimates do not guarantee future results.

Note: The data covers the period from January 1996 to December 2020. Cliffwater Direct Lending index data is from September 2004 to December 2020 and assume a 3% management fee. Infrastructure returns are a listed market proxy in the form of the Dow Jones Brookfield ex MLP Global Infrastructure Index. Private Equity Returns are from Cambridge Associates US Private Equity Index and the volatility is calculated using a public market equivalent of listed MSCI US Small Cap Value Index with a 15% leverage. Farmland and Timberland series use the US NCREIF Index data and assume a 1.5% management fee.

As of February 18, 2023

Source: Pascal Böni & Sophie Manigart (2022), Preqin, Cambridge Associates, NCREIF, Datastream, MSCI, Cliffwater and AB

What about future returns? We've made the point in recent research that a regime change has taken place, so it would be a mistake to simply assume that future returns will be the same as past returns, and we would worry if investors are using that rationale.

In the case of private equity, which has taken the bulk of inflows over the last decade, the increase in buyout multiples to record levels and increase in the cost of debt raise a question: Is there still an illiquidity premium for that category, in aggregate? We forecast that the net-of-fee future return on the *average* private equity return will be similar to public equity,[5] but there's still a wide dispersion of outcomes. So, within private equity, the more successful funds are a key element in the ability of active management to enhance end-client returns. This means private equity is set to be more of a narrative about manager selection and alpha than beta. In our view, marginal flows into private assets will likely head to areas other than private equity.

Private credit should be able to attract a larger part of these inflows, with growth supported by the retreat of traditional credit providers. Most segments have a floating rate, which can be explicitly helpful as one part of the response to hedging portfolios against higher inflation. Private credit has evolved from being a niche segment of lower-rated corporates to a broader set of return streams—in many cases linked to parts of the economy that are harder to access via public markets.

Set against this are constraints, of course. Given the recent growth of the category, we're often asked whether enough private credit managers have active experience in managing assets through a proper default cycle. Given these concerns, the assessment of managers probably needs to be enhanced.

We can also make the observation of a general decline in quality across the whole spectrum of credit in recent decades. One can see this, for example, in the observation that 46% of investment-grade credit is at the lowest possible rating in the investment-grade continuum, whereas in 2014 only 36% was at this level. This raises a system-wide question: Has risk gone up and, if so, how should investors be compensated? This issue isn't specific to private credit—we see it as part of a much broader problem. We've long argued that if investors wish to preserve purchasing power, they need to increase risk levels (this is why we called our recent Black Book *A Painful Epiphany*). The only question is: What kinds of specific risks do investors wish to expose themselves to? What fits with their liquidity needs, time horizon and skill areas?

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[5] See our black book *A Painful Epiphany*

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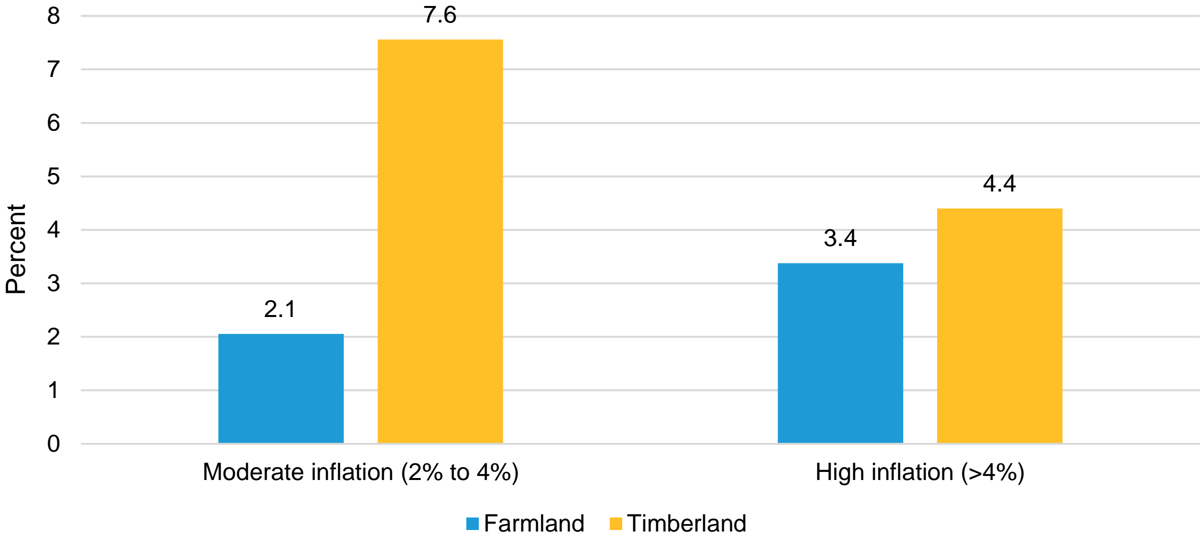
The infrastructure proxy in Display 14 is weighted toward traditional infrastructure that includes airports. The mix within infrastructure is shifting toward green technology, which is changing the nature of the return streams and will likely make it a longer-duration category with lower income. This mix is still highly valuable, especially if it includes a built-in inflation-linked component, but it will also shift the return/risk ratio of the asset class. We suggest that an important dynamic is that developers of assets, such as a wind farm, need capital, so there's a framework for expecting demands from developers and investors to be met. Private natural-resources assets, including farmland and timberland, are also part of the potential real-asset pool. The attractive feature is a demonstrated ability in the past to generate positive real returns over extended periods of higher inflation. If assets are managed the right way, they might also fulfil investors' environmental, social and governance (ESG) goals.

DISPLAY 14: REAL RETURNS FROM FARMLAND AND TIMBERLAND IN DIFFERENT INFLATION REGIMES



Historical analysis and current estimates do not guarantee future results.

The analysis uses annual data from 1972 to 2020. US CPI index is used to convert nominal to real returns. Moderate inflation regime is defined as periods where US 10 year breakeven inflation rate was between 2% to 4%. High inflation regime is defined as breakeven rate higher than 4%. Pre 1997, the 10-year break-even rate is a backcast of implied inflation calculated by Jan Groen and Menno Middeldorp from NY FED

December 31, 1950 through December 31, 2020

Source: Colm Fitzgerald, NY FED, Thomson Reuters Datastream, USDA and AB

Lastly, there are other asset-backed private-credit asset classes—commercial real estate, hard assets such as aviation and shipping, and specialty finance strategies such as consumer and residential mortgage lending. While they weren't referenced in Display 14 because of their more limited historical data, they represent potentially attractive allocations, given their linkage to the real economy and cash-flow profiles.

Private assets and the future of asset allocation

The investment industry loves silos. There are the divisions between active and passive, public and private, and quantitative and fundamental, to name but a few. We would argue that they are all fake, to some extent. The dividing line between active and passive is dynamic and a grey area. Likewise, the public-private dividing line is not as stark as many investors believe.

Ultimately, issuers, whether corporations or other entities, need to raise capital—and can do it through a range of channels, be it equity or debt, listed or unlisted. It would be more appropriate to think about overall portfolio design as curating a spectrum of return streams that span these channels rather than making hard distinctions between public and private. The emergence of secondary markets for private assets and the long-term potential for tokenization of real assets are part of this theme.

Asset owners face the prospect of lower real Sharpe ratios for their portfolios, which we argue demands a continued asset-allocation shift. That response includes considering how to integrate illiquidity premia and active return streams into portfolios in the most risk-efficient way. Another element is targeting exposure to parts of the real economy that have been harder to access in traditional listed markets. Set against this are counteracting forces, such as an intensified focus on liquidity risk, considerations on the impact of a default cycle and questioning the scale of illiquidity premia in some cases. These headwinds may count against private-market allocations in specific circumstances, but overall we think private assets have a significant role to play in the appropriate asset allocation for a new investment regime.

INVESTMENT RISKS TO CONSIDER

The value of an investment can go down as well as up and investors may not get back the full amount they invested. Capital is at risk. Past performance does not guarantee future results.

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