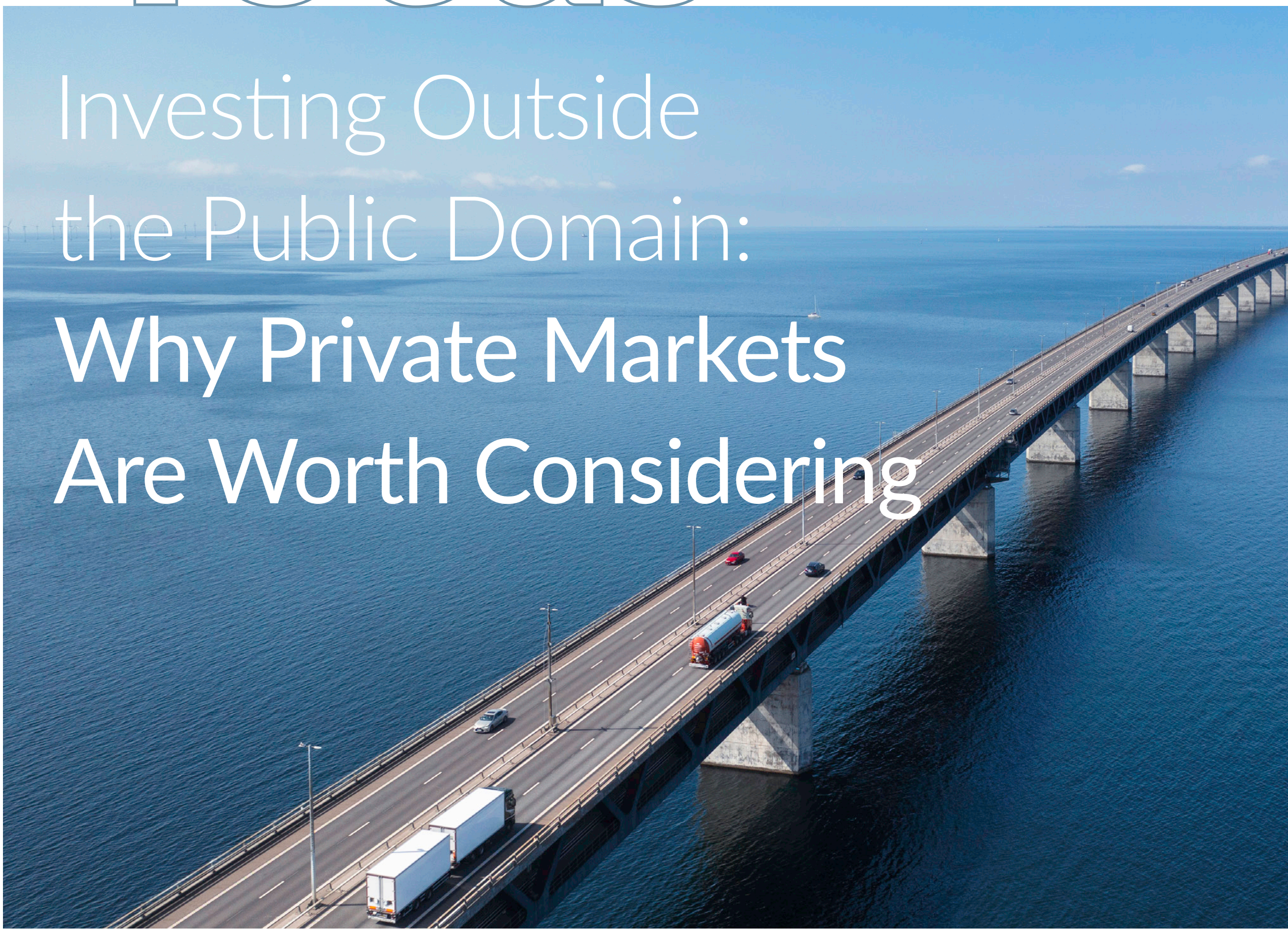
Thursday 14 November 2024

focus



Investing Outside the Public Domain: Why Private Markets Are Worth Considering

Private markets are one of the fastest growing areas of the investment universe. Investors have been attracted by the strong returns and diversification benefits they have delivered. There are trade-offs, most typically a lack of liquidity, a long investment horizon, and uncertainty around timing of returns. In our view, however, for many investors the benefits private markets provide outweigh the costs.

FORSYTH BARR

...Uptake of private markets, and private equity in particular, has grown across the investor landscape...

Growth of private markets

Private markets, which encompass private equity, private debt, venture capital, and real assets such as infrastructure, real estate, commodities, and natural resources, have seen significant growth over the last decade. According to McKinsey, global private market assets under management grew to over US$13 trillion in 2023, up from approximately US$4 trillion a decade ago.

The rise in private markets has been led by institutional investors, such as pension funds, sovereign wealth funds, and endowments, which have turned to private markets for higher returns, to diversify portfolios, and reduce public market volatility.

Uptake of private markets, and private equity in particular, has grown across the investor landscape. A 2023 Goldman Sachs global survey of wealthy family offices found that they had, on average, a 26% allocation to private equity, second only to 28% in public equities.

Recently, more options have become available for individual investors. Boston Consulting Group estimates that by 2025 high-net-worth investors will, globally, have US$1.2 trillion invested in private equity funds, up 2.4 times from 2020.

Shrinking public markets

One factor contributing to the growth of private markets is that less companies are going 'public' and listing on a stock exchange. The number of publicly listed companies in the United States peaked in the mid-1990s at nearly 6,000 and has since declined by about half. In the early 2000s in New Zealand there were around 200 listed companies. Today it's about 140.

The decline in the number of publicly listed companies reflects a range of factors, including:

- Greater availability of private capital through the growth in private equity, private debt, and venture capital funds.
- The number of initial public offerings (IPOs) or new listings of companies has fallen sharply, especially since the early 2000s.
- Listed companies have increasingly been acquired by private equity investors. 'Take-private' transactions are significantly outpacing IPOs.
- The regulatory requirements and costs associated with public listings have risen significantly and can be prohibitive, particularly for smaller companies.

Public markets can be characterised by high share price volatility and a focus on short-term performance. This can pressure a company's management to prioritise short-term profits over long-term initiatives. Private companies may be better placed to invest for the long-term, with less concern about the impact on short-term earnings and share price fluctuations.

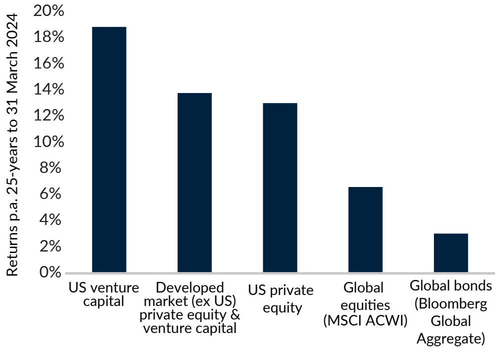
Many of today's companies, especially in the tech sector, have asset-light business models that do not require significant capital investment. This contrasts with capital-intensive industries that have historically been more likely to publicly list to raise funds for major capital investment.

The benefits of investing in private markets

Private markets offer benefits to investors beyond traditional asset classes.

1. **Higher potential returns:** Historically, private equity has provided higher returns than public markets.

ASSET CLASS RETURNS



Source: Bloomberg, Refinitiv, Cambridge Associates, Forsyth Barr analysis

2. **Active ownership:** Private equity managers typically have a hands-on role in the businesses they invest in, influencing decision-making, strategy, and operations, providing greater opportunity for active management to enhance a company's value.
3. **Diversification:** Private markets enable investors to gain exposure to: (i) parts of the economy that are difficult to get exposure to through public markets (particularly in New Zealand), and (ii) unique investment opportunities, such as early-stage companies or special situations.
4. **Alignment of interests:** The interests of private market managers and their investors often align with managers investing significant amounts of their own capital in the fund or transaction.
5. **Long-term focus:** Unlike public companies, which may face pressure to deliver short-term results, private market firms can focus on long-term growth and value creation.

Education is important for investors considering private markets

While we see merit in private markets, investors should be mindful of trade-offs before allocating to this asset class.

1. **Liquidity constraints:** Unlike public markets, where stocks can be bought and sold with ease, private market investments often come with long lock-up periods. Investors may have to commit capital for five to ten years before realising a return. Private markets may not be suitable for investors who need liquidity or have short-term financial goals.
2. **Valuation and transparency:** Private investments are less transparent and are valued less frequently than securities listed on public markets. This can make it more difficult for investors to get an accurate and timely assessment of the performance of their investments. Additionally, valuations in private markets are often based on estimates, leading to a higher degree of subjectivity compared to publicly traded assets.
3. **High minimum investments and costs:** Private market investments typically require significant minimum commitments, making them less accessible to retail investors. They also generally involve higher fees, reflecting factors such as the specialist expertise involved, and the active and time-intensive nature of the management. Investors need to weigh these costs against potential returns when determining their allocation.
4. **Manager selection:** Success in private markets can be heavily influenced by the skill and experience of investment managers. A top-tier manager can provide significant value through better deal sourcing, operational improvements, and strategic exits. Conversely, underperformance by managers can have a substantial impact on returns, meaning investors need to conduct thorough due diligence and assess the track record, expertise, and alignment of interests before committing capital. Importantly, private market managers introduced by Forsyth Barr have been through our thorough due diligence process.

...For anyone considering investing in private markets, seeking expert guidance and education is essential...

Private markets worthy of investors' consideration

Private markets provide investors with opportunities for enhanced returns, diversification, and active ownership benefits. They do come with unique challenges, including liquidity constraints, higher fees, and the need for diligent manager selection. For investors able to navigate these complexities and commit to a long-term horizon, private markets can play a valuable role in a diversified portfolio. For anyone considering investing in private markets, seeking expert guidance and education is essential — there are a broad range of available options, each with very different return ambitions, risks, and trade-offs. Forsyth Barr advisers are always happy to discuss whether private markets might be appropriate for your portfolio, and the options available.

If at any time you want to discuss investment options and opportunities, your Forsyth Barr Investment Adviser is available to provide you advice and assistance.

0800 367 227

forsythbarr.co.nz