

Private Markets – once in a generation opportunity for charity and endowment portfolios?

Historically, charities have invested in public markets to enhance returns. In this paper, **Loui Quelcutti** considers the benefits for charity and endowments to consider private markets both in terms of the long-term investment case and the short to medium term opportunity.

Key takeaways

- ▶ Whilst private market investments have been a feature of endowments in the US for many years, such investments have not been as prevalent in the UK charity and endowment market, particularly in small to medium sized charities.
- ▶ However, the 2022 gilts crisis in the UK defined benefit pensions market and the subsequent pension scheme funding improvement has resulted in a market dislocation that provides an opportunity for long-term investors to purchase high quality private market assets at significantly discounted values. Recent data, explored later in the note, shows discounts of c.10-25% across a range of different private market assets.
- ▶ Many charity investors are well placed to take advantage of this opportunity and should consider the wider potential benefits private market assets bring to a charity investment portfolio. These include:
 - Return enhancement;
 - Increased diversification;
 - Inflation linked cashflows; and
 - Scope to have significant sustainability impact.
- ▶ There are additional considerations that come with investing in private market assets, including operational governance aspects as well as additional costs. It is therefore important for charity investors to seek advice prior to investing to ensure these considerations are suitably managed.
- ▶ XPS have a rich pedigree in this space as we have been helping institutional investors access this area of the investment universe for over 10 years. We would be delighted to discuss the current opportunity and how your portfolio can benefit.



Private markets present a great long term investment option for many charities and endowments, with a real opportunity to take advantage of reduced prices in the short to medium term.

Loui Quelcutti
Senior Investment Consultant

Private market assets – widening the investment toolkit

The universe of investment opportunities can be broken down in several ways. Common methods include asset class, geographical split, size, growth versus defensive, etc. Assets can also be categorised based on how they are traded between investors. Traditionally, charity portfolios in the UK have had significant allocations to publicly traded assets, for example, the stocks that make up the MSCI All Country Index. Only the very largest companies have the scale to raise capital via public markets. Having the ability to trade ownership stakes publicly provides strong liquidity for an asset given its ownership is made up of potentially hundreds of thousands of investors that have a central location to trade shares in the company.

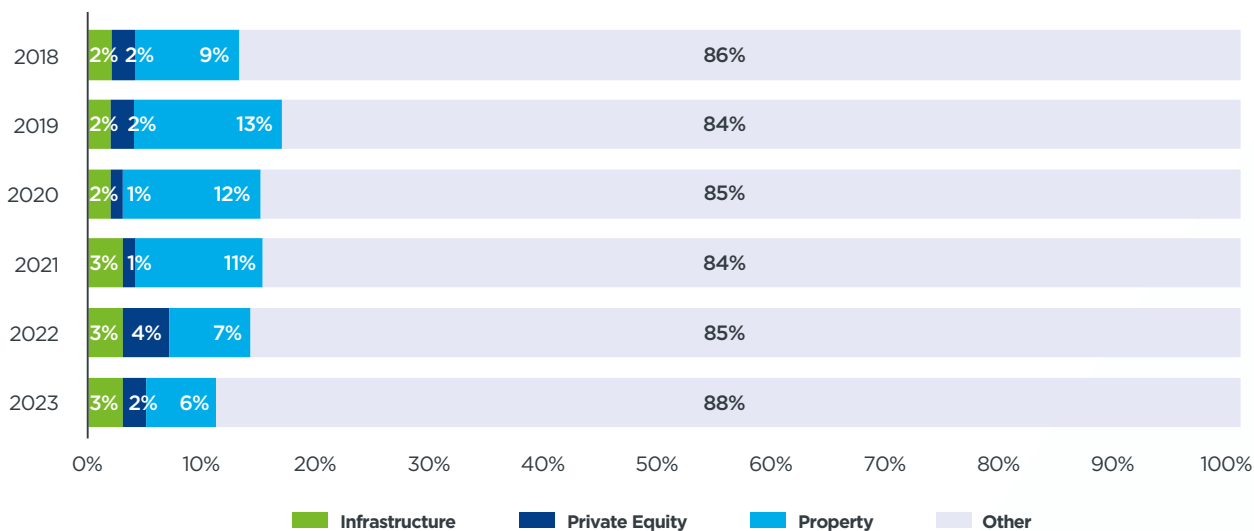
As the name suggests, private market assets are bought and sold via private transactions and are the primary method of raising finance for many firms. Being privately held means the asset is much less liquid than publicly traded counterparts.

There are several longer-term benefits of private market assets for charities that are explored later in the paper:

1. Return enhancement through illiquidity premium;
2. Inflation linked cashflows of private market assets benefitting charity;
3. Diversification from traditional asset classes; and
4. Greater scope for ESG impact.

Allocations to private market assets in charities has gradually decreased in recent years, as shown in the chart below from the 2023 Newton Charity Investment Survey.

Charity allocations



Source: The 2023 Newton Charity Investment Survey



It's important to note that private markets are not a new asset class for charities. Indeed, private market assets have been a staple in many larger endowments, particularly in the US, for many years.¹

¹ Famously the 'Yale Model' introduced over 30 years ago, promoted the use of non-traditional investment such as private markets for their return potential and diversifying power. <https://investments.yale.edu/about-the-yio>.

The current opportunity

Over the course of 2022, the UK Defined Benefit (DB) pensions market saw a seismic shift as government bond yields rose at an unprecedented pace, reflecting the global macroeconomic shift to a rising interest environment in order to curb rampant inflation. This had led to several effects;

1. In most cases, higher bond yields led to better funding positions for DB pension schemes reflecting that liability values fell relative to the value of assets. The below chart illustrates this large improvement in funding in 2022 and beyond.

Funding level progression of typical UK DB pension scheme



Source: XPS Radar - UK DB Pension Scheme

The charts above are based on data from The Pensions Regulator, the PPF 7800 Index and the XPS data pool. The assumptions used in the UK:DB long-term target basis include a discount interest rate of gilt yields plus 0.5%. The assumed asset allocation is 16.9% equities, 20.0% corporate bonds, 6.9% multi-asset, 5.1% property, 3.8% private markets and 47.3% in liability driven investment (LDI) with the LDI overlay providing a 60% hedge on inflation and interest rates

2. Pension Scheme assets became smaller, leading to private market assets becoming a larger proportion of overall scheme assets (therefore leading to some rebalancing).

Many DB pension schemes choose to transfer their assets and liabilities to an insurance company when a strong funding position is reached as this is often seen as the most secure way to ensure the member benefits are paid. Many schemes have found themselves in a very strong funding position much earlier than expected and now need to sell their private market assets earlier than expected to fund this.

Private market fund managers often operate vehicles that have a fixed life, known as closed ended funds, and the original intention of the DB pension schemes was to wait for the vehicle to reach the end of its intended life and receive back capital. Many DB pension schemes are forced sellers and the pressure on schemes to sell means many private market assets are currently trading at discounts on the secondary market to their Net Asset Value (NAV). We believe now is therefore an attractive time for investors with long-term time horizons such as charities to take advantage of the dislocation and purchase these assets. Additionally, open ended private market funds, such as some property funds which provide investors with the ability to continuously buy and sell their holdings are also trading at attractive prices.

The diagram below shows discounts currently available for a selection of private market assets. Whilst the average price of these funds is trading at a discount, there are a wide range of prices of funds within any given asset class and it's important to receive expert advice when trading in these markets. XPS have experience in helping clients to optimise value when trading assets through our **XPS Xchange** service, which was developed to help clients when buying and selling illiquid assets by accessing the widest possible range of potential buyers and sellers.

XPSXchange
Specialists in managing illiquids

Private Equity Buyout



Private Debt



Real Estate



Infrastructure



Notes: XPS observed secondary market average pricing is based on a mosaic approach using primary and secondary data sources, including interactions with markets participants.

Longer term reasons charities should consider private-market assets

We believe the dislocation outlined above presents a great opportunity for charities to allocate to private market assets at an attractive price. There are also a number of longer term, more strategic reasons why private markets can help charity investors achieve their investment objectives that would merit an allocation even if the current pricing opportunity was not present.

Alignment of time horizons and return enhancement

Many charities are funded by permanent endowments which therefore have very long-term time horizons versus other institutional investors. This enables them to benefit from the 'illiquidity premium' available to investors who can 'lock up' a proportion of their capital for a period of time. For closed ended funds time horizons vary but fund manager vehicle lives vary from 3-6 years (for private credit) up to 10-13 years (for private equity). Open ended funds are typically a lot more liquid than this and provide investors with greater liquidity requirements the opportunity to access some of the other benefits of private market assets without locking up capital for as long.

Inflation linked cashflows

Charity portfolio objectives are often focussed on retaining the real purchasing power of the portfolio (i.e. investment returns that keep up with inflation) plus a spending rule. Private market assets often have a strong inflation linkage in their return profile, for example, the rental income from property investments is often inflation linked, as is the income from many infrastructure assets (for example utility assets often have government contracts that specify prices can be increased with inflation).

Diversification from traditional assets

Private market assets provide a much wider opportunity set than investing in public assets alone and hence can provide valuable diversification vs traditional asset classes such as equities and bonds. Some asset classes such as infrastructure are also easier to access available via private markets.

Greater scope to make an impact

XPS are noting an increasing proportion of charity investors integrating additional objectives alongside traditional financial objectives. These additional objectives are often linked to the wider aims of the charity. Whilst investors in traditional listed asset classes can use voting rights to engage with underlying companies and influence change, investors in private market assets also have an ability to influence investee companies. For private equity, infrastructure and property, the fund manager will often own the entire asset (or be one of a small number of owners) which provides significant influence. Even with private credit, the fund manager will often request a seat on the board as a precondition of providing financing.



An allocation to private markets can open up a range of investment opportunities for many charities that have hitherto been accessed only by the biggest charities.

Alasdair Gill
Head of Charities & Endowments

Private market asset considerations

Whilst there are clear benefits to adding private market assets to charity investment portfolios, there are also some key challenges to consider before making an investment. XPS has extensive experience helping institutional investors manage these challenges.

Illiquidity

The degree of the illiquidity can vary but for closed ended funds ranges from several years from some private market assets to around a decade for others. Whilst open ended funds provide an opportunity to invest in private market funds without the same level of liquidity requirements, it's important to still consider the liquidity requirements of the charity. As noted earlier, the long-term time horizon for charity investors means many entities can tolerate the illiquidity but it is important to consider the profile of cash inflows and outflows as part of the process to determine a suitable allocation to private market assets. It should be noted that private market assets can often be sold via the secondary market in a shorter time horizon if required, but an investor would need to sell at a substantial discount (hence the opportunity described earlier in this briefing note) and this process can still take weeks or months.

Obtaining exposure

The process for investing in private markets can be more intensive from a governance perspective. Often a charity investor would need to make several commitments to private market funds, with the fund manager drawing capital from investors when an attractive opportunity has been identified. This means that charities may need to make numerous disinvestments from assets held elsewhere over a period (usually over 18 to 36 months), rather than investing in the asset class in one go. These governance requirements are clearly not insurmountable but are more intensive versus public markets where exposure can be obtained quickly. Open ended funds are investment funds that have an indefinite investment horizon and look to maintain exposure over time. These types of funds can work well with a number of longer-term asset classes like infrastructures where there isn't a natural point at which the investment moves into the next phase and an exit is desirable.

Higher fees

Private market assets usually have higher fees than their public market counterparts. That said, the wider opportunity set and illiquidity premium means net of fee expected returns are also usually higher. The higher fees are due to the increased requirement for active management in private market assets. Taking the purchase of an infrastructure asset as an example, resource is deployed to undertake extensive due diligence on the asset, financing needs to be arranged, a variety of legal and regulatory steps are required etc. Ongoing costs are also higher as the asset needs to be managed on an ongoing basis, for example, a private equity fund manager will often have extensive involvement in the management of a company. To some extent some of the additional asset management costs reflect costs that public companies also incur, albeit within the company's operations.

Summary

Private market assets can provide charity investment portfolios with attractive returns and therefore contribute to meeting many investors' investment objectives. There are numerous ways charities can access private market assets and the preferred approach will likely vary depending on the objectives and constraints of the individual entity.

The market dislocation caused by premature pension scheme disinvestment has provided an attractive opportunity for charity and endowment investors with long-term time horizons to make an allocation to private market assets. There are some hurdles associated with these assets, but we believe they could be a worthwhile addition to many charity and endowment portfolios.



Key actions for charity trustees

- 1 Understand** your charity's liquidity requirements and if there is scope to explore private market opportunities.
- 2 Speak** to your investment adviser about the private market opportunities available and which ones may be right for your charity's needs.
- 3 Consider** using **XPS Xchange** in order to potentially purchase underpriced private market offerings.

About us

XPS can help you navigate the ever-changing landscape of the financial markets, whilst ensuring organisations keep up to date with regulatory responsibilities, such as those laid out in the recently updated Charity Commission guidance. With decades of experience across both investment consulting and research, XPS offers insightful independent and impartial advice to the charity sector.

We advise pension schemes and their corporate sponsors as well as charities and endowments, and have over £110bn of assets under advice.

Find out more

To discuss any of the issues covered in this edition, please get in touch with **Loui Quelcutti** or **Alasdair Gill**. Alternatively, please speak to your usual XPS contact.



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