Finding relative value in private markets through active portfolio management

When it comes to private markets, many investors like to stick to long-term allocations, but a more flexible approach, deviating from pre-defined targets, could unearth additional return via relative value.

It's challenging for investors to navigate the constantly evolving world in which we live – with social, economic and market dynamics continually bringing fresh challenges. These have real implications for investment opportunities. As the landscape changes over time, why shouldn't investment portfolios and targets dynamically change too?

Most private markets portfolios are created with long-term investment horizons in mind. However, prevailing market conditions, shaped by transformative and regional trends, impact different investment opportunities to a varying degree over time.

This is why it can pay to be tactical with portfolio allocation and be flexible and adaptive to market opportunities. Active portfolio management, underpinned by relative value views, is already common practice in public markets. However, the same cannot be said for private markets even though this can be a source of significant additional performance.

What relative value looks like in practice

In a nutshell, a relative value approach involves deviating from pre-defined targets to take advantage of evolving market dynamics. What does this mean in practice, though?

In private markets, relative value views can be implemented by moving overweight or underweight across different portfolio dimensions, which we introduced in the third piece in this series. Examples of this are illustrated below.

With the right amount of flexibility, a relative value approach can be very accretive to portfolio returns. Our own analysis has shown that, pivoting the investment strategy toward relative value opportunities has historically added 100-150bps performance per annum to multi-asset private markets mandates over the last five years[1]. That said, unlocking relative value in private markets requires several pre-requisites. ›

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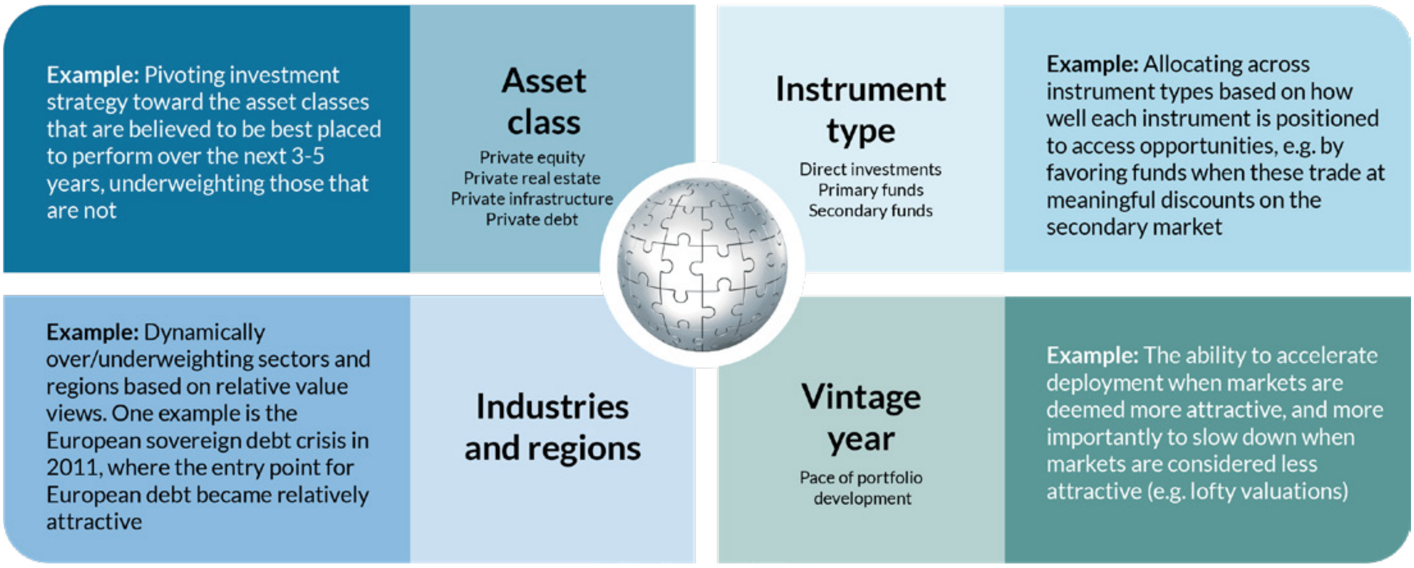
Examples of relative value levers in private markets



1. Source: Partners Group (2022): Performance measured during 31 December 2016-31 December 2021 across 10 Partners Group mandates, investing across at least two private markets asset classes with a > 5 years track record. The outperformance of relative value mandates was calculated by comparing the actual IRR achieved, with what would have hypothetically been achieved had each mandate been deployed exactly in line with its strategic asset allocation. Therefore, the performance differential captures the impact of relative value overweights and underweights. For illustrative purposes only. Past performance does not guarantee future results. There is no assurance that the stated strategy will materialize.

Three key ingredients for a successful relative value approach

First, the investable universe must be wide enough for a manager to look for relative value opportunities. For example, a European Private Real Estate closed-ended fund would commit investors to this strategy over the respective investment period (typically three to five years): should the economic outlook for Europe change over this time horizon, or the outlook for real estate assets in the region deteriorate, they would not be able to pivot away without making a new fund commitment. Therefore, investors may wish to grant managers the ability to dynamically optimize asset allocation within their initial commitment. This can be achieved by broadening the investment scope across one or more of the relative value levers mentioned earlier. In our example of a European Private Real Estate fund, this could mean expanding the geographic scope (e.g. including US investments alongside European ones) and/or the asset class scope (e.g. include other real assets – such as infrastructure equity – alongside real estate assets).

Second, implementing relative value requires investors to take a view. This may sound obvious, but it is easier said than done. Significant resources and expertise are required to map out the private markets universe, and then credibly decipher between different potential areas of investment. This is not just due to the nature of private markets, which are not as easy to access as public markets. The skills of the manager, as well as their investment process, must be right too. Deep knowledge of private markets is not enough: taking credible views on the relative attractiveness of investment opportunities requires relative value to be at the center of a manager's decision-making process.

Third, a strong and consistent flow of new investment opportunities to draw upon is critical for managers to implement their views in a diversified way. It is one thing to establish relative value views, but another to take advantage of them. That is why the strength of investment sourcing, combined with a thorough due diligence process, is the final piece of the puzzle that provides investors with greater dynamism for their portfolio, helping to maximize the value-add potential of relative value while also maintaining a focus on high-quality opportunities. Without a surplus of ideas, managers may fall short on implementing their relative value views or may have to compromise on investment selection.

Taking advantage of relative value with bespoke client solutions

In the first piece of this series, we discussed some of the challenges investors face in reaping the full alpha potential of their private markets allocations, advocating for a more active approach to portfolio management. In this context, bespoke client solutions can represent an attractive alternative or complement to traditional closed-ended funds thanks to their flexible structures, which allow investors to capitalize on active portfolio management and minimize the inefficiencies of investing in private markets.

What are bespoke client solutions?

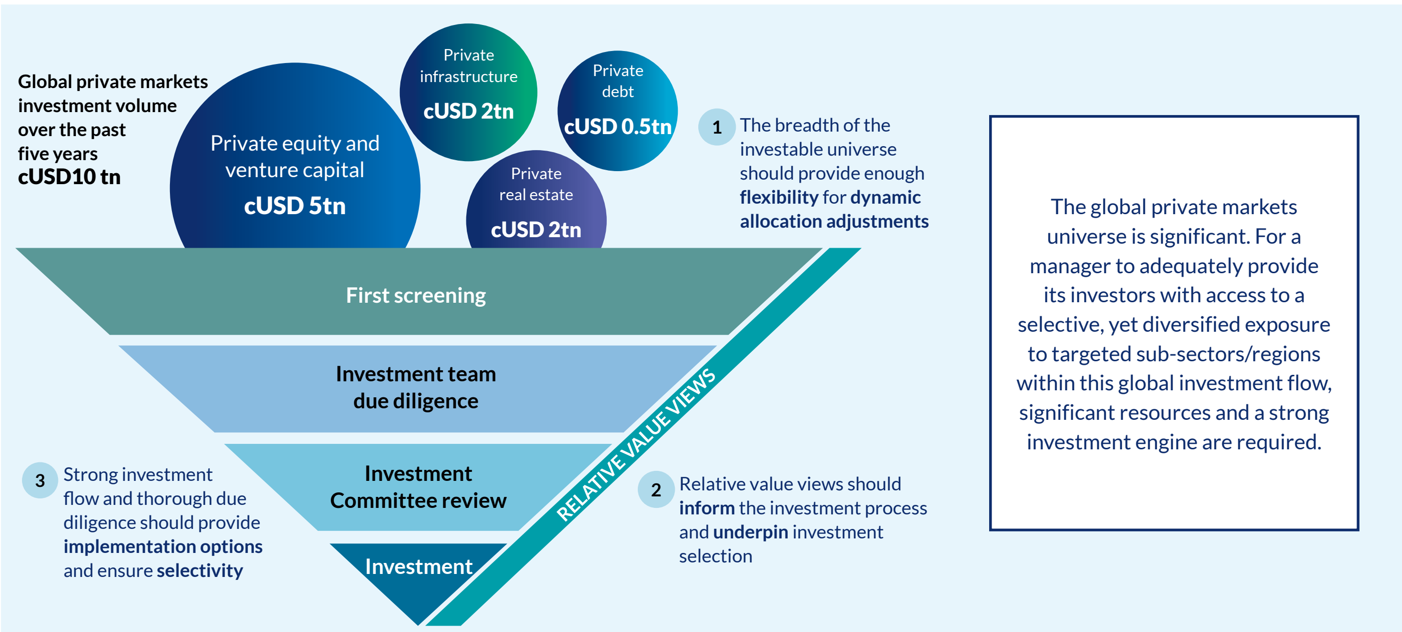
Customized mandates: separately managed accounts invested on behalf of a single investor. These structures are fully bespoke in their design and implementation, catering to specific objectives and requirements. They are typically multi-asset in nature and often feature an unlimited / extended investment life.

Evergreen programs: open-ended private markets commingled funds. These structures have no fixed term and accept subscriptions and redemptions on a regular basis, continuously (re-)investing capital. These features allow investors to gain immediate access to a diversified portfolio with a single commitment and to maintain such exposure over time until redemption.

In particular, the following client characteristics mean bespoke client solutions offer investors an effective route for an active approach to portfolio management, underpinned by relative value considerations:

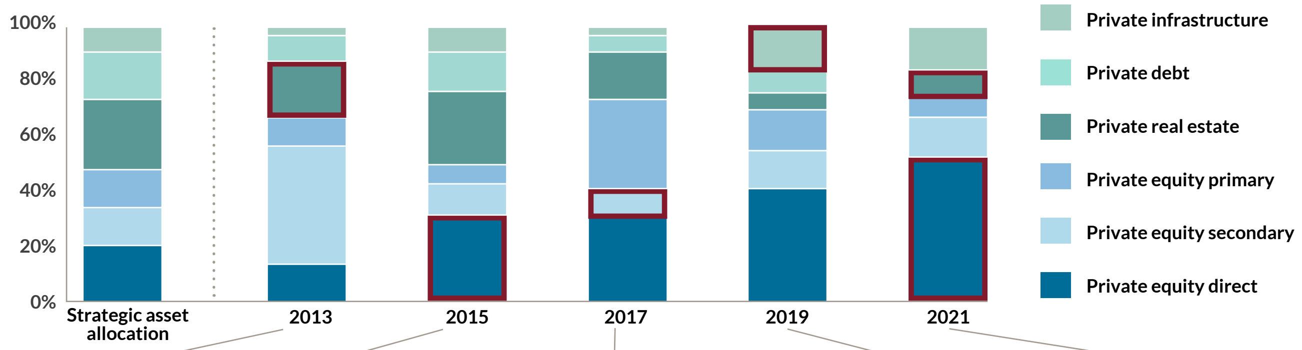
- **Broad horizons:** bespoke client solutions are often global, multi-asset class and multi-strategy in nature, meaning they can overweight/underweight flexibly with limited restrictions.
- **Evergreen nature:** many bespoke client solutions are structured to be evergreen (no fixed end date), or to benefit from extended investment lives that go beyond the traditional three-to-five-year ›

Incorporating relative value into a manager's investment engine



Source: Preqin (2022). Private markets investment volume by asset class includes investment transactions completed between 1 January 2017 and 31 December 2021. For illustrative purposes only.

Relative value adjustments can be an important source of additional alpha



Overweight real estate secondaries on the back of broad investment flow with diverse underlying assets available at double-digit discounts to NAV	**Increased focus on private equity direct opportunities,** looking for mid-market leaders that can grow internationally	**Underweight private equity secondaries** as prices remained at elevated levels; selectively invested in inflection assets with years of value creation ahead of them	**Increased focus on private infrastructure,** where an increased energy efficiency megatrend conveyed attractive opportunities	**Overweight direct private equity** investments able to benefit from transformative trends, creating value and resilience in current environment. **Remain selective on real estate**, where the pandemic is likely to have a longer lasting impact

Source: Partners Group (2022). For illustrative purposes only.

investment period. This allows for greater scope to take advantage of relative value opportunities over time.

- **Flexible investment pacing:** bespoke client solutions allow managers to adjust the investment pace in line with the prevailing market environment, introducing the possibility of adding additional alpha. This can be done by deploying more capital in attractive market environments and slowing down deployment in more challenging ones. In the case of evergreen funds, which offer investors the ability to subscribe and redeem on a recurring basis, a manager can further add value by accepting new subscriptions in accretive environments and dialing them down in more troubled periods.

> **Investors should consider how much flexibility they enable a manager to take advantage of relative value opportunities.**

To illustrate how bespoke client solutions can dynamically adapt to capitalize on relative value over time and increase long-term returns, we consider a real-world evergreen private markets fund.

The chart above shows the adjustment of how new money was deployed over time, relative to the initial strategic asset allocation. Over the past ten years, relative value calls have added over 150bps per annum to investment-level returns[2].

Relative value can be an important source of additional alpha in private markets. Therefore, investors should consider how much flexibility they enable a manager to take advantage of these opportunities: do investment guidelines enable relative value? Can the manager credibly take views? Are they equipped to implement them effectively? By keeping these questions in mind, investors can put themselves in the best position to benefit from relative value over time. ■

2. Source: Partners Group as of 31 December 2021. Past performance is not indicative of future returns. There is no assurance that similar results will be achieved. The performance presented reflects model performance of the Partners Group platform, invested in the manner shown, and does not represent performance that any investor actually received. Returns are investment IRRs, gross of Partners Group fees. Performance figures in USD, calculated over the last 10 years until 31.12.2021, using FX rates as of 31.12.2021 (currency neutralized).

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