

Private Markets

A Guide for High-Net-Worth Investors



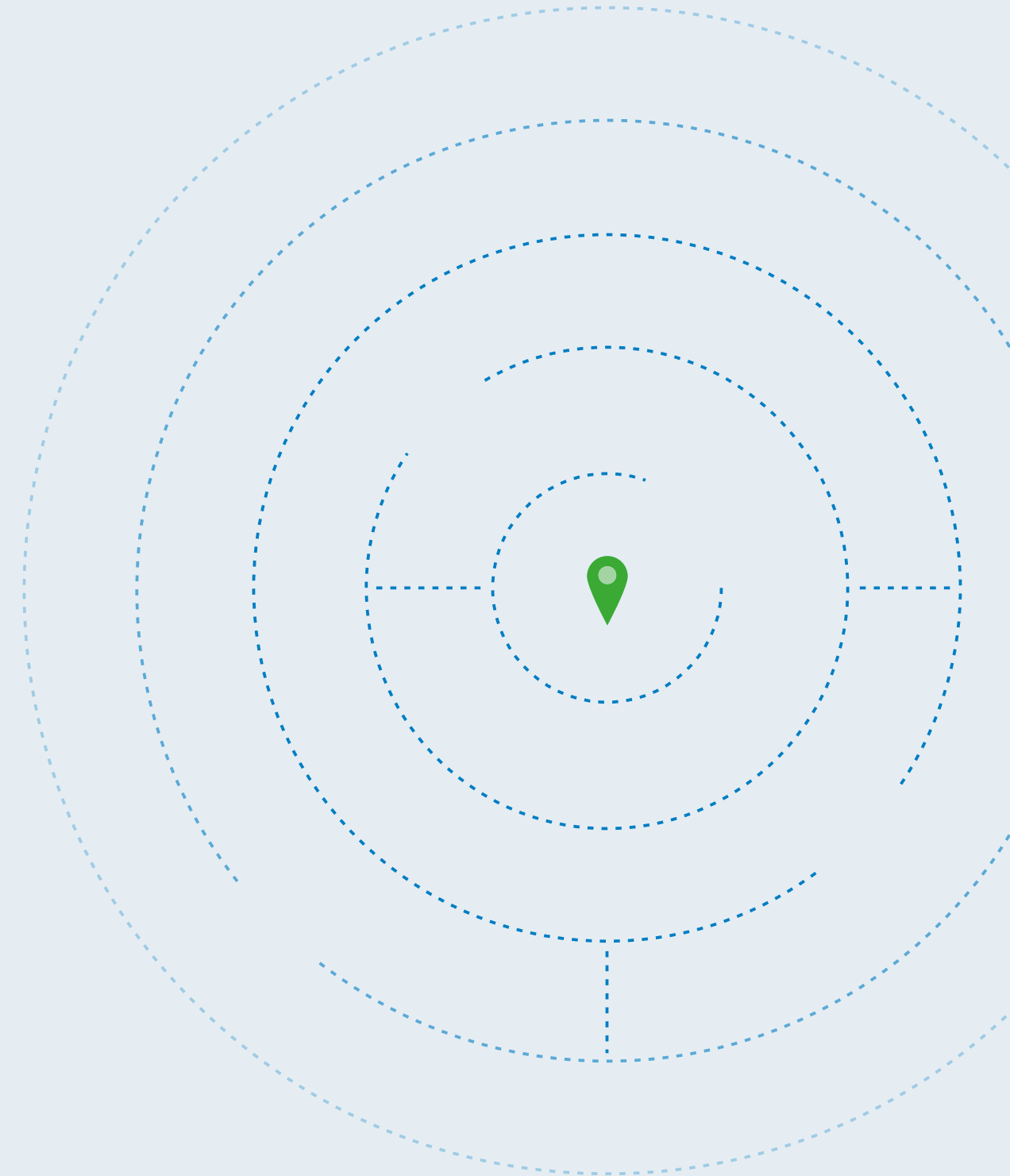
Meeting long-term return objectives is a tall order for any investor. Further confounding the problem for individual investors? A short list of opportunities.

For advisors and their high-net-worth or mass affluent clients, investment choices have been largely relegated to just two asset classes: public equities and fixed income. But these markets represent only a small – and shrinking – opportunity set.


Increasingly, much of the corporate world's growth, innovation and returns are occurring in private markets, a target-rich environment that dwarfs the size of the public sphere. For decades, large and sophisticated institutional investors – including pensions, endowments, foundations – and ultra-wealth individuals have tapped private investments to help meet their portfolio objectives, steadily increasing allocations to this alternative asset class.

Today, innovative fund structures are removing some of the hurdles associated with private market investments, making the asset class more accessible to a broader swath of investors. In other words, individual investors may finally be able to realize the industry's return potential in their own portfolios.

While the democratization of private markets is a welcomed change, investors would do well to educate themselves before wading in. Drawing upon Hamilton Lane's 30-year history in the space, this guide provides an overview of the private markets to those less familiar with them. We answer some of the basic questions you might have about an asset class with enormous potential, but that represents an entirely new frontier for many individual investors.



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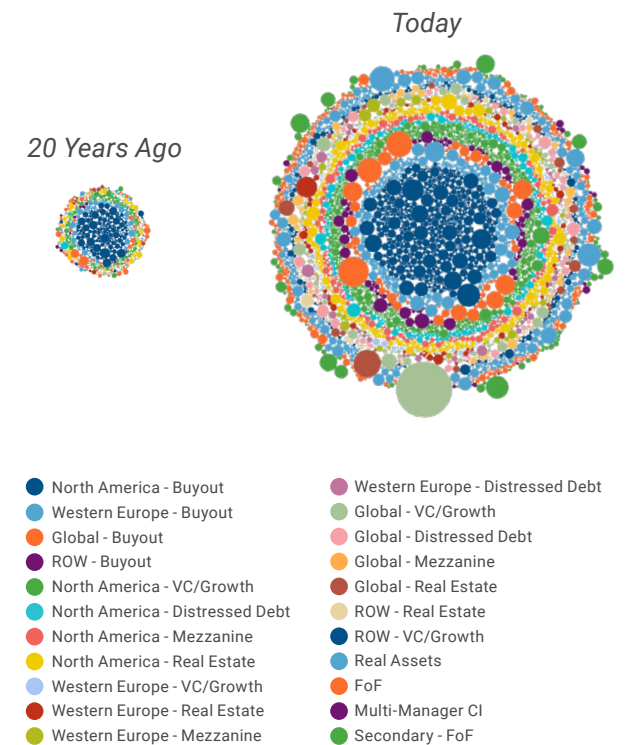
First, what are the private markets?

While private equity is the most recognized private markets investment category, it is only one strategy of several that comprise the broader industry. Private investments also include private credit, real estate, infrastructure and real assets.

At the most basic level, private investments are assets or financial instruments that are not listed on an exchange. They are investments made directly into private companies and are utilized to increase the value of the company by making operational or strategic improvements, supporting growth initiatives, enhancing management teams, improving technology and more.

Since private investments don't trade publicly, there is generally less readily-available financial information about them. The investments are also less liquid than a stock bought and sold on a major exchange, or a corporate bond that trades over the counter. The limited liquidity and transparency in private markets are two of the biggest differences from public markets and are factors an investor should be aware of before allocating to the asset class.

Private Markets Industry



Source: Bison Data via Cobalt (November 2020)
Note: Each circle represents a manager and is categorized by strategy as defined by Hamilton Lane.

What are the different types of private market investments?

Private market investing is an expansive universe that includes many investment types. This table provides a definition of several of the most common investment strategies and their corresponding characteristics.

Buyout (Small, Mid, Large, Mega)	Equity investments in which a company is acquired, typically with the use of financial leverage. These companies are mature and generate operating cash flows.	<ul style="list-style-type: none"> ➤ Core of Private Equity Portfolio ➤ High Return Potential ➤ Experienced Managers
Venture/Growth Equity	Investments in startup and early stage, often technology-based companies; investments in relatively mature companies looking for growth over the long term.	<ul style="list-style-type: none"> ➤ Highest Potential Return ➤ Higher Risk ➤ Long Term
Credit	Participation in the debt financing of a company, usually as part of a change of control transaction. These loans can range in terms of seniority within the capital structure (who gets paid first) and interest rate.	<ul style="list-style-type: none"> ➤ Current Income ➤ Downside Protection ➤ Shorter Duration
Real Assets	Investments in physical assets (e.g., building, pipeline, timber) that are long-term in nature. Investment strategies include Real Estate, Infrastructure and Natural Resources.	<ul style="list-style-type: none"> ➤ Inflation Protection ➤ Yield-Generating ➤ Low Correlation
Secondaries	Investments in existing portfolios or direct investments often purchased at a discount based on remaining fund life and quality of assets.	<ul style="list-style-type: none"> ➤ J-Curve Mitigation ➤ Discount Valuations ➤ No Blind Pool
Direct Investments	Investments made directly in a company or asset alongside a general partner. These investments are minority, passive positions made on the same terms as the GP.	<ul style="list-style-type: none"> ➤ Cost-Effective ➤ Enhanced Returns ➤ Targeted Exposure



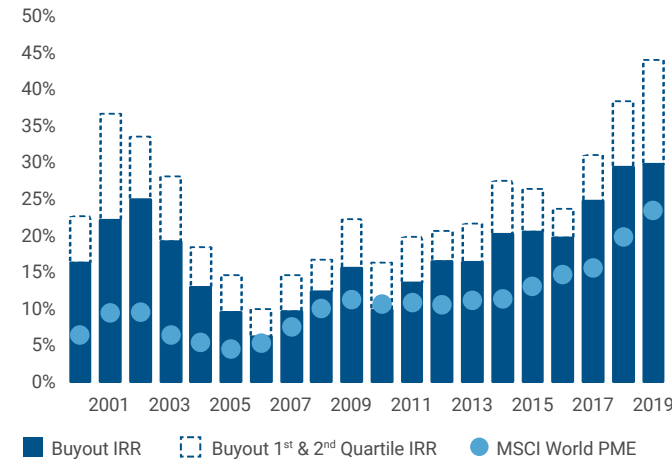
Why should investors
consider private markets
in their portfolio?

One of the biggest factors drawing investors to private markets has been performance. Case in point: Private equity and private credit have outperformed global public equity and credit markets, respectively, in 19 of the last 20 years.

A variety of factors drives the outperformance. First, there is a liquidity premium associated with private markets: Higher returns may be compensation for longer lockup periods with investors' capital.

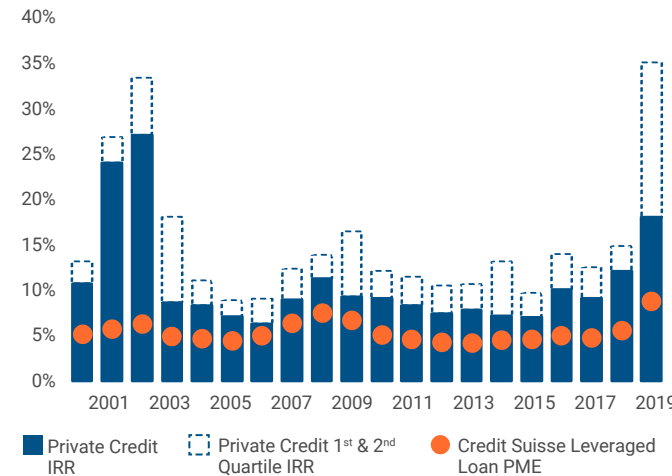
Another reason could be that companies are staying private longer and, in turn, have the potential to experience more of their growth and innovation before going public. For instance, in the technology sector, the average age of a new public company has gone from 4.5 years in 1999 to more than 12 years today.¹ As tangible examples, two of the 10 largest-ever tech IPOs waited 10 and 12 years, respectively, before going public, long after they had disrupted the industries in which they operate.

Buyout IRR vs. PME
By Vintage Year



Source: Hamilton Lane Data, Bloomberg (July 2021)

Private Credit IRR vs. PME
By Vintage Year



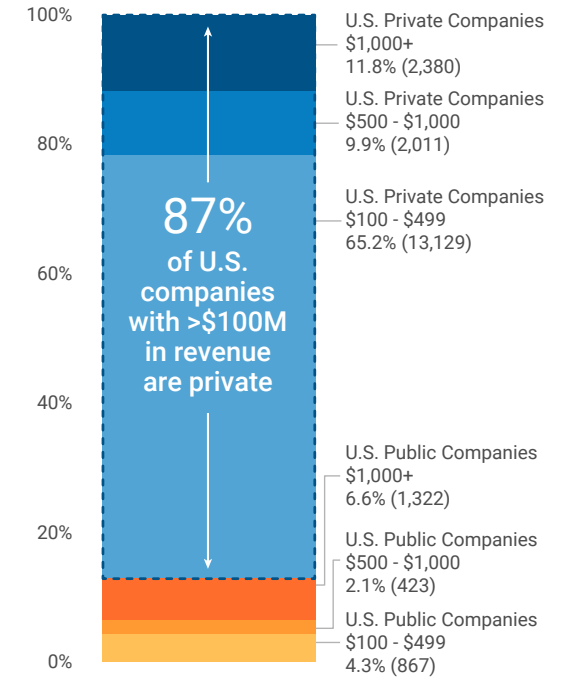
Source: Hamilton Lane Data, Bloomberg (July 2021)

Private markets may provide diversification benefits

Private investments can also be a valuable diversifier. This is due to the much wider pool of companies within private markets. There are more than 17,000 U.S. private companies with annual revenues above \$100 million, compared with just 2,600 public companies with those same revenue levels. (See diagram.)

Over the last two decades, public markets have become increasingly more concentrated, dropping from more than 7,800 publicly listed companies at the beginning of 2000, to roughly 4,800 at the end of 2020.² The dwindling number of public companies has made diversification beyond them even more important.

U.S. Public & Private Companies
By LTM Revenue (\$M)



Source: Capital IQ (Feb 2021)

DEFINITIONS

IRR: The internal rate of return is a metric used in financial analysis to estimate the profitability of potential investments

LTM: Last twelve months

PME: Public market equivalent

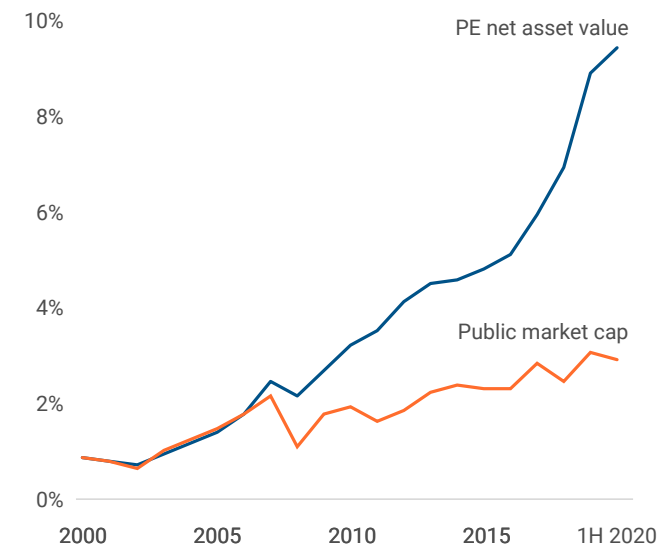
¹<https://www.skadden.com/insights/publications/2020/01/2020-insights/private-pre-ipo-investments>

²Source: Research by Professor Jay R. Ritter, University of Florida

What is the history of private market investing?

Large institutions were early entrants into the private markets and remain the predominant investors. Many have dedicated a substantial investment, with private market allocations for pensions, endowments and foundations generally ranging from 10% to 20%.³ The chart below shows how the asset class has grown over the past two decades as more investors have come to realize its benefits.

Growth of PE Net Asset Value and Market Cap⁴
2000–1H 2020



Source: World Federation of Exchanges, Preqin

Looking ahead, allocations could continue to grow. A recent McKinsey & Co. study on private markets found that 79% of surveyed limited partners plan to increase their private equity allocations. Twenty-three percent plan to increase them considerably.

Even though more institutions have carved out a meaningful allocation to private investments, high-net-worth and mass affluent investors have not had the same opportunity to participate. Large investment minimums and private markets' illiquidity were two of the largest barriers for individual investment. But as the asset class has grown — and public markets have shrunk — private market managers, and even the SEC, have explored opportunities for private markets to become more accessible to individual investors.

As a result of those efforts, more large private market managers with institutional investor bases have developed fund structures that remove some of the traditional barriers to retail participation.

³Source: McKinsey Global Private Markets Review 2021

⁴Net asset value equals assets under management less dry powder. Market cap is based on the total market cap of companies globally.



How do investors access the asset class?

Historically, institutional investors have pursued several different avenues to access the private markets. They run the gamut from direct investments into companies, commingled funds that invest in a mix of private companies, multi-manager funds that invest in a group of investment managers' funds, and separately managed accounts.

However, these vehicles often have high investment minimums (e.g., \$5 million to \$10 million), long lock-up periods (e.g., 7-15 years) or require clients to be qualified purchasers, such as institutions, endowments or ultra-high-net-worth. These features tend to present barriers for many advisors and their high-net-worth and mass affluent clients. In recent years, however, some of the large institutional private market managers have launched traditional '40 Act mutual fund structures to make private markets more accessible to these investor groups.

Evergreen funds: opening the door to private markets

Often referred to as evergreen funds because of their perpetual fund life, investors have the ability to enter and exit these '40 Act vehicles throughout their existence. With some evergreen funds, the investor's capital is immediately deployed into an already existent pipeline of investments. This is quite different from traditional private investment structures, where the investor commits capital for a multi-year period and the fund's general partner calls that capital at various times to make investments once targets have been identified.

Thoughtfully constructing a diversified and fully invested portfolio is crucial to the success of these vehicles. For individual investors, certain evergreen fund structures may present potential advantages. Those that are able to deploy capital quicker can eliminate cash drag. Early deployment also allows for exposure to the private markets sooner, a critical detail for individual investors who have never had exposure, and do not have longer-term investment horizons the way a pension fund or endowment might. Below are some additional differences between evergreen funds and other investment vehicles:

- **Diversification:** A potential benefit of evergreen funds is that they often invest in more than one type of private market strategy. A fund may hold private credit, private equity and secondary investments, for example. This helps manage liquidity and gives the end investor broad exposure to private markets in one vehicle, instead of having to find different managers for each investment type.
- **Governance:** As a '40 Act fund, evergreen funds are subject to SEC regulations, and are governed by a fund board. These measures provide an extra level of oversight that traditional investment structures do not possess.
- **Taxes:** Evergreen fund investors report the investment using a 1099. This is a simpler process than the K-1, a multipage document that is required for illiquid private partnerships.

- **Investment minimums:** Historically, the minimums for participating in a private equity partnership were around \$5 to \$10 million. Evergreen funds offer a lower entry point, typically from \$50,000 to \$100,000, depending on the fund and share class.
- **Liquidity:** Traditional private equity partnerships include a 10-12-year commitment. Evergreen funds, however, may offer monthly or quarterly redemptions. Redemptions may be limited, and, typically, the fund will allow only a set percentage of total assets to be redeemed in a quarter. (As we cover later, investors should approach the asset class with a multi-year, long-term approach.) However, a vehicle that allows greater liquidity should nevertheless provide more flexibility than traditional partnerships and remove a hurdle for some individuals.

How are investors paid?

Investors in an evergreen fund receive periodic distributions, typically on an annual basis. When an investor exits the fund, they are compensated based on the fund's net asset value, which is calculated monthly and determined by an independent, third-party valuation firm. This is different from traditional mutual funds, where the NAV is calculated daily.

Side-by-Side Comparison

	Traditional Private Equity	Evergreen Funds	Mutual Funds
Structure	Typically closed-end limited partnerships	Open-ended fund structures with no termination date; typically priced monthly	Typically open-ended structure; priced daily
Investor Eligibility	Qualified purchasers	Usually qualified clients or accredited investors sometimes open to all investors	Generally open to all investors
Capital Deployment	Multi-year commitment period	Potentially fully deployed upon investment	Fully deployed upon investment
Administration	<ul style="list-style-type: none"> • Involves processing capital calls and distributions • Often greater than \$5M USD minimum commitment 	<ul style="list-style-type: none"> • No capital calls • Lower minimum investment (e.g., 50-100k) 	Daily liquidity requires strict liquidity regulation and can lead to increased volatility due to market action
Liquidity	7-15 year lock-up period	Limited liquidity; typically, quarterly	Ability to redeem daily
Diversification	Multiple manager selection requiring resources or Fund of Funds	Diversified exposure through single allocation	Strategy specific
Asset Allocation	Static and difficult to maintain target allocation	Potential for diversified exposure through single allocation, but strategy specific	Either dynamic or tied to benchmark depending on strategy
Tax Reporting*	K-1	1099	1099

*U.S. investors only.

“
 When retail investors participate in our markets, how broad a spectrum of investments do they have? I think that spectrum has been getting relatively smaller. Because we have fewer public companies, companies are waiting much longer in their life cycle to go public, which by definition means that retail investors have less access to the market as a whole. And I fear, less access to companies that are well-established, but still growing.”

-SEC Chairman Jay Clayton

How do private market portfolio managers add value?

The role of the portfolio manager in a private investment is quite different from a portfolio manager investing in public equities. In short, the private market portfolio manager is much more involved in helping a company create value.

A portfolio manager investing in public equities makes an investment based on a view that prospects or earnings for the company are poised to improve beyond what is implied in the current stock price. But the portfolio manager isn't taking a hands-on approach in helping the company drive those future earnings. In contrast, a private fund manager is more engaged with the companies, providing guidance and input on the company's strategy and direction, while also keeping an eye on risk. For example, the private fund manager may give input on products or capabilities the company should develop, a strategic acquisition the company should pursue, or new technologies the company should utilize.



What are the risk/return tradeoffs of private markets?

As previously mentioned, private equity and private credit outperformed their respective public market counterparts over the last two decades. Data also reveals that in the lowest-returning five-year period from 1995–2020, as seen in the chart to the right, neither private equity nor private credit experienced negative performance.

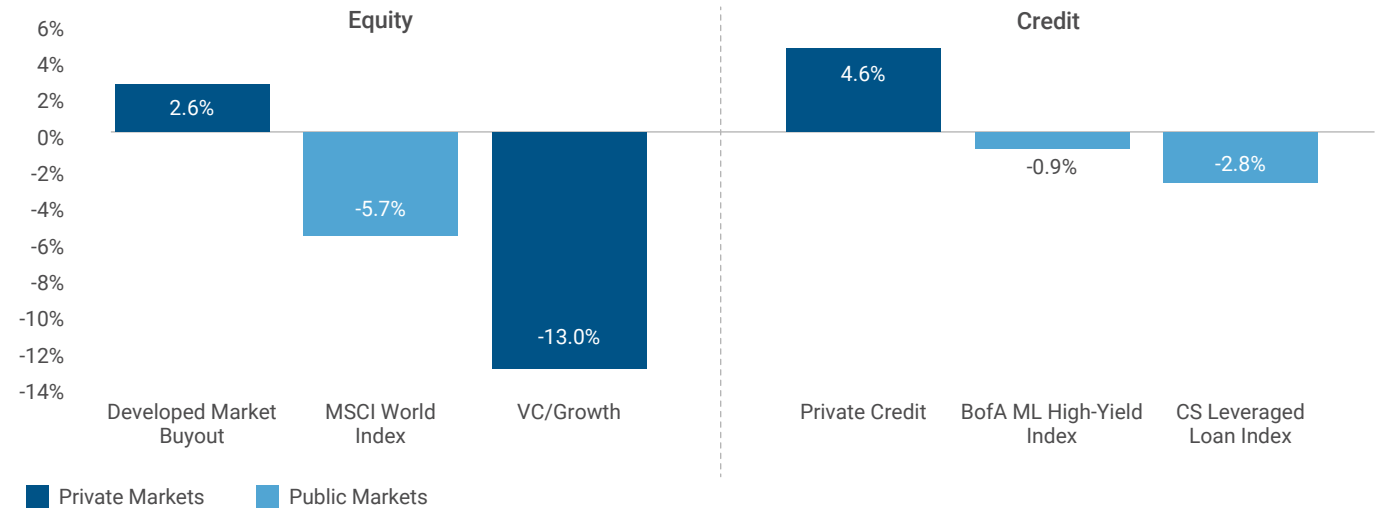
Investors have increased allocations to a more diverse lineup of investments, including alternatives, to meet return expectations.

Going forward, many experts believe private markets will have an increasingly important role to play in meeting investors’ portfolio objectives. The chart on the bottom right from Callan Associates, an institutional investment consultant, puts this in perspective.

While the chart suggests investors may want to consider making an allocation to private markets, there are also tradeoffs. The biggest of those, as we’ve discussed, are the long-term nature and illiquidity associated with private markets. It often takes considerable time – years, not months – for private investments to realize their value. As such, investors should approach private asset classes with long time horizons.

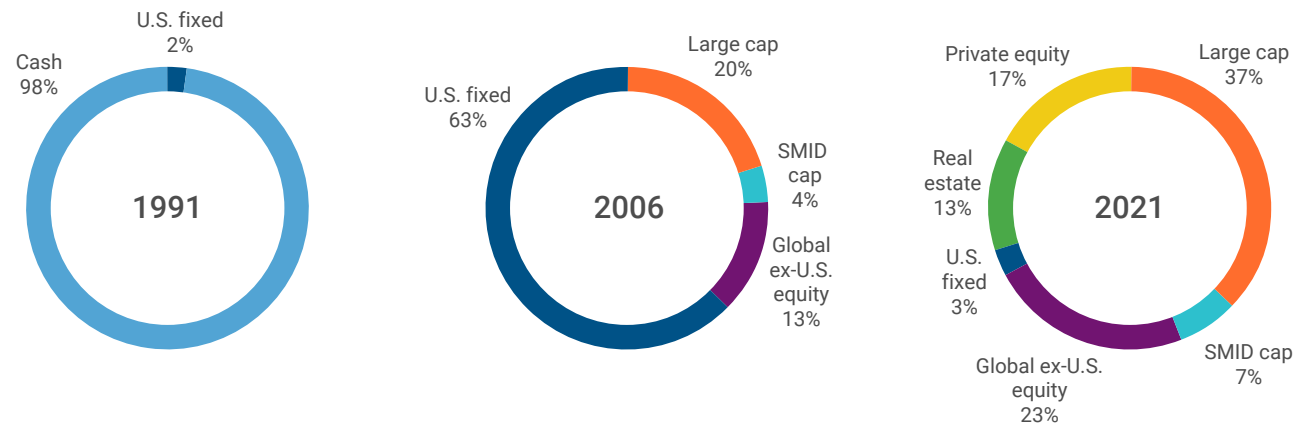
Individuals accessing the asset class for the first time should make sure they have enough liquidity within the rest of their portfolio to support a long-term private investment. To encourage a long-term commitment, many investors use evergreens within their IRAs, intending to let the investment appreciate until retirement.

Lowest 5-Year Annualized Performance 1995–2020



Source: Hamilton Lane Data, Bloomberg (July 2021)

Investor Allocation Seeking to Earn 7.0%



Source: Callan Associates



The road ahead

Private market investments have been a staple of institutional portfolios for decades, and increasingly some of the barriers to investing are being eliminated, effectively enabling greater access to the asset class for high-net-worth and mass affluent investors. Those groups may want to consider taking advantage of the broadening market opportunity. Some of the most compelling reasons? The strong historical performance of the asset class, as well as the depth of the opportunity set relative to the shrinking number of publicly listed companies that can provide meaningful diversification for investors.

While the returns and diversification benefits have been attractive, first-time private market investors should be aware of the differences between private investments and traditional stocks and bonds. But given the opportunity, investors may benefit from making private investments a part of their broader portfolio.

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As of July 1, 2021



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Private Equity
International



PEI SI 30
2020



PEI 300
2020

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