IMpact: An investment management podcast series

Episode 2: Democratizing private markets: A more accessible investment landscape

Host:
Reese Blair, partner, Deloitte & Touche LLP

Guest:
Timothy Braude, head of multi-asset solutions, Goldman Sachs

Reese Blair: *Hello, everyone. I'm Reese Blair, your host of IMpact, the new investment management podcast series from Deloitte. IMpact brings you hot takes and fresh perspectives from top experts in the industry. Whether we're discussing issues like regulation, recession, or resiliency, we'll take a deep dive into the latest news, trends, and challenges facing investment management professionals. Our mission is to help you focus on investing in what matters. So, tune in, learn something new, and walk away with insights that will help you make an impact on the IM industry and the world around you.*

Reese Blair: Welcome back, IMpact podcast listeners. We are returning for our next episode in the series, and today, we will be discussing the democratization of private markets.

Wow, that's a bit of a mouthful, and certainly a sophisticated area for investors to navigate. However, joining us to help break it down is Timothy Braude, the global head of multi-asset solutions at Goldman Sachs. Welcome, Tim. We're so excited to have you with us today.

Timothy Braude: Thank you, Reese. That enunciation was beautiful, and I'm really excited to be here.

Reese Blair: Before we tackle the issue at hand, Tim, and I really want to get your thoughts on the latest developments in the investment space. I'm curious, specifically, the private market space. Could you maybe share a little bit about your background and what your role specifically entails at Goldman?

Timothy Braude: Sure. I'm the global head of multi-asset solutions, and before taking on this role, I was a portfolio manager for OCIO clients—that's "outsourced chief investment officer" clients—with a focus on pensions and insurance companies.

I started my career as an actuary and graduated with a degree in mathematics, but I really started getting interested in private markets during the 2005 to 2007 time frame. I think for many of us, we remember that quite well, and that was one of the biggest leveraged buyout bubbles of all time.

Reese Blair: Indeed. I should have told you to maybe [make] an announcement warning or something for folks who probably remember that time! [laughs] But Tim, thank you for that introduction.

And listen, to set the stage for our listeners, I'm wondering if maybe you could perhaps elaborate on exactly—I know what it means, but I'm sure some of our listeners may be curious—what exactly are private investments? And maybe walk us through some of the mechanics of how they work.

Timothy Braude: Of course, and I think most people are familiar with private markets. We see lots of articles about private equity and private credit and the role that they play in various companies. But it's always good to set the stage. And so, when folks on the investment side use the term "traditional investments," we're often describing investments that are long-only, publicly traded investments or securities such as stocks, bonds, and cash.

Alternative investments ultimately are used to describe everything else. And so, that obviously leads us to a very wide range of potential assets and securities. These could include assets such as real estate, commodities, or simply describe nontraditional approaches to investing within special vehicles, such as those used by private equity or hedge funds.

In fact, private investments are often accessed by qualified investors through an investment fund. Most private investment funds are through what are called drawdown vehicles, where investors commit capital during the manager's fundraising cycle. Capital is called during the investment phase when the general partners, or GPs, are putting money to work as they come across attractive investment opportunities. And finally, money is distributed back to the investors or limited partners, or LPs, during the harvesting phase.

For many private investments, this entire cycle can take 10 or more years, and even longer. Recently, there has been more focus on semi-liquid funds, which are evergreen in nature. The overall private space has grown significantly in recent years and will likely continue to grow as an attractive option for investors.

Reese Blair: Thank you, Tim. I appreciate you walking us through that. That was very helpful context [and] background. I think everyone's now "calibrated" to what we're talking about as it relates to private investments, and that whole life cycle was extremely helpful.

So, maybe what I think we'd like to do is maybe take a dive into what's driving this trend that you talked about. This trend of the liquidity, this private space growing significantly in the past couple years. You said that was a trend that's been happening recently. So, maybe unpack what's driving that trend, any other observations that you're seeing around the current investing landscape? How have investors been reacting to this trend that you're seeing?

Timothy Braude: Yeah, and if we take a step back, one of the big drivers of why a lot of investors started to move more into private markets was just the search for increased returns and increased yields. If you think about the time period following the global financial crisis, where interest rates across the developed world were close to zero, every additional basis point of yield that you could eke out of an investment was really important to the bottom line of how a portfolio did.

In general, they are becoming more and more popular for qualified investors as a means of diversifying their portfolios and producing opportunities for higher risk-adjusted returns. Typical investors in privates may include wealthy individuals, venture capitalists, angel investors, and, most importantly and historically, large institutions who are accredited investors like pension funds and insurance companies, just to name a few.

We've also seen the number of companies that have gone private or stayed private increase significantly over the past 10 years, which is yet another reason why there's a demand for this part of the market across people's portfolios. While the current market is still broadly made up of those drawdown vehicles that I talked about a little bit earlier, evergreen funds are becoming much more common, and GPs are increasingly focusing on perpetual capital.

So, when we talk about perpetual capital versus these drawdown funds, the whole idea of having to go out into market, fundraise for a new vintage or a new strategy, get money in, get money committed—the whole process is really arduous. It can be operationally intensive. And so, if there's a way to create a structure whereby somebody says, "I want you to manage my private equity capital and just keep the money and keep on reinvesting the money as you get proceeds," it's a much more straightforward structure.

It's much more operationally seamless and streamlined. And ultimately, for the private equity firm or for the end general partner, it's much more sticky capital. And so, that's something that we've been seeing a lot more of. Additionally, we've been seeing a push to open the door to private investments that's not only driven by investor interest, such as defined contribution plans in the US and the UK, but actually by governments themselves.

And so, as an example, in the UK, the Mansion House speech from 2023 opened the door for UK-defined contribution plans to invest in UK companies to boost the UK economy, which is all a way of saying we're okay with defined contribution plans in the UK having allocations to private equity.

Finally, collective investment trusts, or CITs, are starting to be used much more often in defined contribution plans—and in target date funds in the US, which are a very common, popular election choice for individual participants who are ultimately looking to have a professional create a more diversified portfolio for them.

Reese Blair: That's fantastic, Tim. And one of the things that we've been seeing here at Deloitte. I mean, we've been seeing that trend as well. I'll tell you from the Deloitte private company outlook, 88% of companies are actually turning to equity financing to raise capital, as opposed to going to the more traditional bank loans, debt financing, etc.

All of this information about what folks are doing with defined contribution plans and how governments are even looking to using these private investments to boost their economy—curious to maybe, if you could unpack for us some of the benefits and upsides of these private market strategies? What's so attractive to investors? And on the flip side, what are the risks and potential downsides?

Timothy Braude: So, I'm going to start by giving you two stats that even as I say it, I find quite amazing. So, first, in 2000, there were about 7,800 public companies. Today, there are only about 4,300. Number two, 87% of the US companies with more than a $100,000,000 in revenue are private. Now, when you talked about that 88%, I was actually worried that you were going to steal my second stat. So, I'm glad that we both see something that's close to 90%, but they're a little bit different.

But the bottom line is that private markets are giving investors access to parts of the economy, particularly high growth areas that are unavailable via public markets anymore. And so, we've really gone from a world where founders and owners are looking to exit and get into the public markets, to one where staying private for longer is possibly the preferred choice.

And so, there's just a whole subset of the US economy and the global economy that if you're not investing in private markets, you're not even touching. That's just on the private equity side. If we think about how changing regulations following the global financial crisis and rules associated with Dodd-Frank are changing parts of the lending economy, and they've opened up opportunities across the private credit market.

And then in addition, we can think about all of the different things that are needed across private real estate and infrastructure builds. And so, there's just this whole world of investment opportunity that isn't available in the public markets.

Private investments could reward active management with higher returns. We hear a lot, and we read a lot, about the death of active management. I personally think that is a little bit overblown. But we do read about it a lot that it's very difficult for the average active manager to consistently beat their fees.

We read a lot about the death of mutual funds and the move into ETFs [exchange-traded funds], and obviously, we know how much traction passive investing has gotten. When you look at public markets, the dispersion between the best-performing managers and the worst-performing managers is significantly less than what we ultimately see in the private markets. And so, there's a lot of opportunity for active management to generate high returns.

You also asked about the risks associated with this. So, it's important to think about the flip side of private investing. And, in particular, obviously, the fact that they have a very different risk profile and liquidity profile than traditional public market investments. Private markets are typically less transparent and less regulated. So, there's a lot more thorough diligence that's needed from investors. They require greater funding commitments.

So, the idea that you're going to make an investment, you need to make a capital commitment to these drawdown vehicles well in advance, then make sure that you have the capital to put in when that commitment is actually called. And obviously, the illiquidity is a big part of things.

Because the fact that there's no trading of these companies in public markets, one of the beautiful things about public equities and even public fixed income is that there's huge volumes being traded on a daily basis. So, you always know the value of what you're holding in your personal account or in your 401(k).

Obviously, on the private side, that's very opaque. There really isn't much trading. And so, these items that are much harder to value, and in many cases, the GPs themselves will use valuation methods that they think are best suited for their investment.

Now, generally speaking, those valuation methods are generally accepted and are industry norms, but at the end of the day, it is still subject to what the GP thinks is most appropriate for that portfolio company or for that private credit or private real estate investment.

And lastly, these things often price on a lag. So, you see a lot more smoothing in private markets just given the fact that you can see gyrations in public markets that just never even make their way into private market prices.

Reese Blair: So much to unpack there, Tim. I don't know where to start, to be honest with you! [laughs] That was amazing. It's interesting that you mentioned that there seems to be this volatility that's happening in the public markets, and I would argue there's probably some level of volatility in the private markets as well, but like you said, on the lag and there's other factors that might've allowed for some smoothing there.

But at the end of the day, we take a step back, one would argue that the market has been volatile over the past couple years. So, maybe wondering if we could just tease that out a little bit more, talking about that volatility. What do you think that means for private investment specifically?

Timothy Braude: Yeah, so as I said, on the one hand, the fact that private market valuations are not subject to these gyrations, and at times, very extreme swings of public markets can be quite beneficial to investors as it doesn't expose their portfolios to drawdowns that are, in some cases, driven much more by sentiment or technical factors than by fundamentals.

Over the last five years, there have been some pretty extreme drawdowns in public equity markets only to be followed by incredibly rapid rebounds, which allows one to really ask whether the value of any one individual company's equity or debt was appropriately valued when the market was at its trough.

We can think about lots of different scenarios where people go to bed on a Friday night, they wake up on a Monday, and the market's down 15%, and by Thursday, it's back to where it started before the week even opened. And so, if all of that is happening, was the value of the company at the nadir—the right number—or not?

On the other hand, the fact that there is this smoothing effect can draw a lot of scrutiny to private funds, particularly in parts of the market that may have been truly overvalued and where GPs do not take the necessary markdowns. On balance, generally, we think this is a positive thing for privates in general, though, extreme volatility can leave portfolios out of balance, and then investors may ultimately end up over allocated to privates.

Reese Blair: You had previously mention that one of the drawbacks of investing in private investments is a lack of transparency. There's some illiquidity challenges, and maybe I want to unpack that concept of illiquidity. Because one often has a negative connotation to illiquidity.

I mean, that's why you have the level 3 investments. It's just this notion of unobservable inputs going into a valuation, they're illiquid, no one's trading them.

But we wouldn't be the IMpact podcast, where we flip things on its head and look at things not from a déjà vu perspective, but from a vujà dé perspective. So, let's flip this concept of illiquidity on its head. Could illiquidity, Tim, be beneficial in the private fund market?

Timothy Braude: Yeah, that is a great question. And so, I actually talk about this a lot. When we think about what are the different risk premia that exist in markets, and when I say "risk premia," these are the things that allow you to generate positive returns because you're taking some risk. The most consistent one is the equity risk premia.

So, just investing in stock, be it public or private, is going to be the thing that most consistently allows you to earn returns over time. Now, oftentimes people talk a lot about the illiquidity risk premia. So, the fact that I can't sell something when I may want to, means that I've got a lockup. And so, I've got to be compensated more for that lockup than if I could sell it readily on the market.

And so, historically, a lot of people think about parts of private investing as also getting this illiquidity risk premia. I actually like to think about illiquidity as providing a different benefit in so far as that illiquidity can save you from yourself. Now, Reese, you and the listeners may be thinking what's Tim talking about?

Illiquidity ultimately, can create discipline because there are not as many opportunities to liquidate a position investors are required to hold. We are oftentimes subject to our behavioral tendencies that we see across the world. And you see markets go down and it's human nature to want to sort of react to that, or markets go up and it's human nature to want to react to that. And so, especially retail investors, liquidate and buy at precisely the wrong times.

So, talk about buy low and sell high. A lot of people buy high and sell low. That discipline that I just talked about can be incredibly beneficial in the context of your portfolio. And I'm going to give you two stats to put that into perspective.

So, if we looked at the S&P 500 over the last 15 years, if you missed the 10 best days, that's just 10 individual days with the best returns, that impacted your annualized return over that 15-year period by 5%. If you missed the 25 best days, that impacted your annualized return over that 15-year period, by 9%. I mean, these are huge, huge numbers because the value and impact of compounding is so high.

And so, not being able to time the market perfectly can really have a huge impact on your nest egg, on your savings. And so, the whole idea of people exiting the markets during periods of volatility, they oftentimes don't get back in the market when things have their upswing. And so, privates can actually, because this illiquidity, create a huge benefit for investors.

Reese Blair: Tim, you unpacked something there just now that made me think about all of these pundits and folks walking around thinking that they have the next best idea, and trying to time the entrance and exits of certain opportunities is a losing game, quite frankly. I mean, that's kind of what I took away from all of that. And that's that. I'm an auditor, Tim. I got to go back and audit that one, but that's extremely compelling. So, I am going to take note of that one and come back to it.

Tim, as you mentioned, I think earlier in the episode here, we were talking about how this space—investing in alternative investments—is really targeted toward sophisticated investors. Maybe wondering if we could probably home in on that a little bit and maybe think about the role that maybe advisers play in this space and how they can be leveraged to assisting sophisticated and maybe not-so-sophisticated investors.

Timothy Braude: Yeah, definitely. So, we've talked a lot about the risk characteristics that make privates, on the one hand, potentially more lucrative investments. But on the other hand, something that requires a lot more diligence and focus. And it is one of the major reasons why the investor demographics are mainly restricted to institutions and accredited investors. The amount of diligence needed in private markets is, frankly, much more intense. And unlike public markets, where regulatory bodies force significant amounts of disclosure, it just doesn't exist.

And so, ultimately, I think there is a space for advisers to play a role not only for less sophisticated investors, but also for investors who are sophisticated but do not have as much experience in the private markets.

And so, it's one of those things where making sure that you have the right support and, ultimately, picking the right manager is going to be critically important. As I mentioned earlier, there is a huge range in performance between top-quartile managers and bottom-quartile managers.

And if in the private markets, you're not picking the right managers, you're not investing with the right GPs, all of the benefit relative to public markets—the illiquidity premium, the ability for management to come in and add value, portfolio companies to unlock value in startups and growth equity firms and things of that nature—can all disappear.

It's one of the reasons that ultimately, when you look at some of the drivers of performance in private markets, the best managers are the best consistently vintage after vintage, year after year.

And so, you don't really read very much about, oh, it's really hard for the best private equity managers to consistently generate top-quartile returns and IRRs vintage after vintage. They have access to deal flow; they have access to a whole set of tools in their toolkit that allow them to consistently generate really strong returns.

And so, advisers can be very helpful in the space to make sure that people don't make the wrong investment decisions. But household names in the private space are household names for a reason.

Reese Blair: Well stated, and taking a page out of Socrates and recognizing "I know that I don't know," why not leverage the help of these sage advisers and folks who have obviously had the track record for a reason. So thank you for sharing that, Tim.

I want to start to bring this plane in for a landing, and one of the things I'm thinking about is just we want to pay homage to the name of our podcast. What would you say is the most impactful takeaway that you would leave one of our listeners with in regards to private markets?

Timothy Braude: So, I'm going to leave you with three things because I think that the human mind, as I've been led to understand, sort of compartmentalizes things in threes. And so, I'm going to go in that direction. And a bunch of it is going to be repetition from things that I've said earlier, because I think some of them are really important.

First and foremost, it's critical to understand the role of the general partner or the role that the GP plays. As I've said a few times, the dispersion between the best managers and the worst can be incredibly significant in private markets. And given the complexity associated with investing in this space, if you don't pick the right managers, you are probably better off just investing in an S&P 500 index fund. So, that's number one.

Number two, it's really critical for investors to understand time horizons and liquidity needs. Only commit funds that you do not need access to for at least 10 years. Because while the secondary market continues to grow, needing liquidity early can be quite costly if you transact there.

And third, it's important to remember that even in private markets, diversification is your friend. Within each part of the private market ecosystem—and then blending private equity, private credit, private real estate, and private infrastructure—constructing a well-thought-out and ultimately diversified portfolio is going to be one of the keys to success.

Reese Blair: Thank you, Tim, for that explanation. Thank you for that summary. Your insights are invaluable and as per usual, you exceeded expectations. I was expecting just one and you gave me a couple, so thank you for that.

I'm going to say before we close, I just want to make sure we don't leave anything on the table here. Is there anything additional that you want to share with our audience before we wrap up for today?

Timothy Braude: Yeah, so, Reese, I'm going to leave you with one hot take. And so, we have heard a lot about tokenization and the impact of a decentralized financial system and what it can do to various parts of the oldl system. And one of the ways that there was a lot of hope that you'd see this sort of burgeoning change in investing in asset management was as it relates to privates.

A lot of people talk about tokenization being this silver bullet to make privates more accessible to the masses. I just don't think that's going to be the case. While tokens have been very popular now for a couple of years and in a lot of different areas, it's not going to be such a quick fix for people hoping to make privates much more accessible for the average investor.

Reese Blair: Oh, that's fantastic, Tim, thank you. I appreciate you sharing that hot take and definitely something for our readers to take back and reflect on. Because you're right, tokenization has been a hot topic, so the fact that it isn't that silver bullet that a lot of people are hoping for, that's really, really interesting. So, I appreciate you sharing that. And listen, I want to thank you, Tim, for the investment of your time.

Thank you to our listeners for tuning in to our IMpact episode today. Look, we've explored the unique opportunities that private investments offer, from the potential for higher returns to the ability to diversify beyond traditional assets.

However, we've also delved into some of the challenges, such as liquidity, transparency, constraints, longer investment horizons, and, of course, the need for careful due diligence and potentially getting some assistance in navigating this landscape.

At the end of the day, private markets can be an incredibly powerful tool in your investment arsenal, but they, of course, require a thoughtful and informed approach.

As always, listeners, until the next time, keep engaging, keep innovating, and keep making an impact.

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