

Growing Trends in Private Markets Investments for Asset Owners

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Speakers

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Rohan Singh

Hello, everybody, and welcome to the BNY Mellon Asset Owner Academy Webinar Series for this year. My name is Rohan Singh and I lead our Global Asset Owner Business Practice, and I will be your moderator for today.

The BNY Mellon Academy is a tremendously important platform where we bring together industry leaders from around the world to share perspectives, and insights, and challenges as well across central banks, pensions, sovereign wealth funds. And the reason this platform is incredibly important is because of the sense of purpose - the purpose being that pensions serve beneficiaries for retirement, sovereign wealth funds, serve states and governments in order to create more sustainability and relief programs. And all of this has been incredibly important, especially during the pandemic as well.

So, we at BNY Mellon take a great sense of responsibility at this, and a great sense of honor and pride at being able to help our organization and our clients in these very important social objectives.

Today's session is on growing trends in private markets investments for asset owners. It is interactive, so we encourage you to submit your questions throughout the webinar by typing your questions in the Q&A chat box, and we promise to try and get back to you as best as we can.

So, let's start. Clearly the global economy, in a constant state of flux, with the post effects of the pandemic, geopolitical tension, mounting inflation, rising interest rates, causing tremendous impact to listed markets. And as we speak to our clients across the world, to pension funds, sovereign funds, central banks, we increasingly hear of concerns around heightened equity valuations and inflation risk, which drives demand for defensive allocations such as private equity and real estate. To ensure return objectives are being met, asset owners are diversifying and planning to increase the allocations to private equity, private debt, real estate, and infrastructure, and to hedge against inflationary risks.

Clearly, there's a cost of liquidity, which has always been a factor for investors with private assets. So, we'll hear from our speakers today on how they're addressing the illiquidity premium. So, our discussion for today will focus on the growing landscape of private markets, how asset owners are allocating capital at the fund level, and tools to effectively manage liquidity risk and governance.

I am joined today and delighted with the three key speakers with vast experience in private market assets. And from two incredibly important organizations - Employees Provident Fund of Malaysia is one of the largest defined contribution pension funds in the world, and Alaska Permanent Fund is one of the preeminent sovereign wealth funds in the world.

First, we have Mohamad Hafiz, CFO of the Employees Provident Fund Malaysia (EPF). Hafiz has over 20 years of corporate experience with vast expertise in private markets. And prior to his current role, he was Head of Real Estate at the EPF. And next, we have Marcus Frampton, CIO of Alaska Permanent Fund Corporation (APFC). And prior to this role, he served as Director of Investments, Real Assets and Absolute Return at APFC. And also, on the panel, last but not least, we welcome our very own Frances Barney, Frances is the Head of Global Risk Solutions at BNY Mellon, over 20 years of industry experience, and a frequent speaker at industry conferences and well-known around the world. Thank you all for joining us today.

So, with that backdrop, let's get into it and hear from our experts. First of all, I want to open up with respect to a more macro question. And Marcus, if I may go to you. Clearly, you have been, your SAA does allocate assets to private markets. What I'm interested in is not so much backward-looking, but given the uncertain investment environment and everything that's going on, how do you look at private market investments going forward? And in particular, which areas, which subsets of that?

Marcus Frampton

Thank you. And thanks for inviting me to this. It's an honor to join. When I started at the Permanent Fund about 10 years ago, we had relatively small private market exposure, we were about 4% in private equity, we had about 4% in what we call private income, which is private credit and infrastructure. And our real estate portfolio was in the low teens percent of the fund. So, around 20% of the fund was in private markets. In the last 10 years, we've really grown. So, private equity today is about 20%. Real estate we were targeting 12%, and private income 9%. And so, when you add in absolute return, which we also lump with those groups, we're over 40% private markets.

And we've kind of hit the point where it's about as big as we'd like it to be. So, we've had this decade of growth. And I think that is reflected throughout the industry. A lot of people have grown their private market allocations. And I think each area has their own themes and drivers that, in any given year, we're emphasizing.

So, if you look at our private equity portfolio, it's about 40% venture capital. We have big efforts in biotech and tech investing. And that's been the place to be the last decade. On a more-- in terms of returns and sector performance - on a more forward-looking basis, we're anticipating a decade of more inflation, higher interest rates, more global scarcity than we've experienced in the last decade. So, on a sector basis, we're a little more interested in energy and materials, and private credit for these higher interest rates. So, we're shifting what we're doing under the surface, but trying to stay the same overall percent of the fund that we have in privates that we've grown to in the last decade.

Rohan Singh

Great, thank you. Thank you for that. That's very insightful, particularly those percentages are certainly greater than what I had expected. So, great to hear.

Hafiz, could I segue to you with that similar question and get your perspective from EPF?

Mohamad Hafiz Kassim

Thank you, Rohan. And again, thank you BNY Mellon for inviting me to the session, quite an honor, to be honest.

So, I think just to give some context, EPF has grown quite dramatically in the last, I would say, 10 to 15 years and, on average, we have grown easily around 7%.

So, when I first joined the EPF more than 10 years ago, our exposure to private markets has been relatively small, even though our allocation has been-- it's always been there from SAA strategy, asset allocation perspective, but it's been quite small, around less than 3%.

So, I guess in the backdrop of growth in our fund, around 6%-- more than 7% annually. And currently, our SAA or our allocation is close to 10%. And just a bit of background as well, what we define private markets, our infrastructure allocation, real estate as well as private equity.

Maybe moving on to the sort of changes we expect on the private market space, I will say a couple of theories. Number one is increasing exposure to co-investment as well as direct investment. I think in the last 10 years we've been a lot focused on the fund investment side. Number two, I would say, is try to find opportunities perhaps where we are—one of the first movers advantage. We have found that in the real estate space, for example, our investment in warehouses, in logistics have actually been beneficial to our returns in the real estate space. And last but not least is our ability to shift between private and public markets. For example, we're looking at, on the real estate space, to actually combine the private market space, as well as REIT where there are short term volatility, where we can take advantage of, especially on the REIT side.

Rohan Singh

Actually, I might just hold you there if I can. And interesting comments about warehouses and logistics. I guess that's a reflection of the new e-commerce and digital economy that we're in. With respect to your private markets set up, you mentioned bringing it together. So, how has it operated? Is it two separate teams? Obviously, the asset classes are separate, or how connected are they? And what efforts are you making to bring it even closer together?

Mohamad Hafiz Kassim

So, from a private markets perspective, the private markets as well as the public markets teams have always been-- have always had a different set up. Obviously, because of-- on the private space, we could be exposed to non-public information, which, I think, we have to be sure that both, for example, the public

space does not have exposure to that sort of information. As well as the sort of research as well as focus could be different. For example, on the fund investment side, our focus has always been on alignment of interest, looking at the track record, as well as motivation, as well as team cohesiveness of our fund investments.

So, what... and as I mentioned to you just now, from a real estate perspective, we're potentially looking at the REIT. But at this point of time, pretty much we are planning to outsource that exposure to fund managers, because we still couldn't get around to ensure that the non-public information is not exposed to the private side. So, from that perspective, it's pretty much different, and a different set up at this point of time.

Rohan Singh

Great, thank you. And Marcus, just keeping this thread going in terms of organizational set ups, because as we talk to asset owners around the world that we increasingly encounter this question, how are others set up? When you allocate capital at the total Alaska level, what's the process in terms of private assets versus public assets? Do you just follow the SAA? Or is there an internal benchmarking or cost of capital process? Is there healthy tension between the public and private markets teams, where they're almost competing for the cost of capital?

Rohan Singh

Oh, and access to capital.

Marcus Frampton

Every year we do an asset allocation study with our general consultant. And I think that's very common amongst state funds in the U.S. to have a general consultant with 10-year capital market expectations. And then we have a long-term mandate of CPI plus 5%, which puts us in a similar zone with state pension funds, and many endowments of 7% to 8% nominal, if you believe 2% inflation, which as I say that right now, it's certainly not the case here in the United States and elsewhere. And for the last couple of years, we've had a very interesting phenomenon where only private equity has a 10-year capital market expectation of over 7%, based on our general consultant forecast. So, you could have an all-equity portfolio that on that basis wouldn't deliver an expected CPI plus 5% return.

And so, I think allocators across the United States and probably globally as well, are faced with this question of, "What do you do in an environment where the low expected returns for equities and fixed income and real estate and probably everything if you're being honest. Do you take more risk to hit that number?" And at this point, the only contributory asset class is private equity based on the consultant projections. Or do you take less risk? Just in recognition of we're in kind of an elevated valuation environment.

I've learned personally towards I want to take less risk. So, I'm always kind of lobbying around that annual asset allocation plan to maintain a minimum of-- I shoot for 25% in what I call "non-market exposed asset classes" with cash, fixed income-- or low market exposure-- cash, fixed income, and absolute return

where we're targeting market neutral hedge funds.

And we've kind of held the line on that. The result has been that, for the last two years, the scored, expected return of our portfolio is lower than our return objective. And that's been, as you might imagine, the source of a lot of discussion and debate, because I started by pointing out that I want to hold the line on where private is now. I think it's appropriate at 40 to 50% -can be more than that, we start having a very unwieldy portfolio with much more privates than that.

So, there is every-- and then week to week, there's an internal discussion on where we want to be relative to our target allocations. And I've chosen to be overweight cash, underweight equities for the last two years, and it's cost us most of the time period. But I'm very-- as... every asset class wants more capital and there's definitely an internal tension. I firmly come down on the side of people should be cautious right now given the environment. And to be completely transparent, that has cost us returns the last two years, holding extra cash, doing less than-- I've been underweight equities almost that whole time. And I've been wrong most of the time. It's felt good the last two quarters or last quarter, but -- on a net basis, whoever took the most risk the last five years did the best.

So, I would caution and be very aware of where we are relative to history, because we're in some pretty unprecedented waters in terms of valuations and interest rates, coupled with inflation, and the Fed hiking.

Rohan Singh

Thank you for that candor and that, I guess, fragility as well, in terms of where you think you haven't done well. And I think our audience will definitely appreciate that. And I think one more interesting area which, again, comes up in a lot of our conversations. And if I compare the two of you, Hafiz is being a defined contribution fund. It's an asset liability management model. He has, of course, the issue of present value, future liabilities to deal with, and discount rates to meet cash flow requirements et cetera. Whereas you being more on the absolute return side, you don't have that-- necessarily that ALM type of business model.

So, Hafiz is it-- I just want to get a quick perspective from you on the illiquidity premium, and as attractive as private assets may be, how do you balance that with that illiquidity premium issue that you are faced with?

Mohamad Hafiz Kassim

So, actually, that's a very interesting question. Because as I mentioned to you, Rohan, EPF, has grown quite significantly in the last 10 to 15 years. And actually, for the first time in our-- what we have experienced in the last two years, the Government of Malaysia has allowed our contributors to actually withdraw money, given the unprecedented circumstances we are in.

So, as a result of that, I would say that approximately, around-- we have been very public on this-- approximately 100 plus billion ringgit, that's USD25 billion, has been withdrawn from our fund in the last two years to various schemes. In fact, we just announced a recent withdrawal of our scheme, which approximately allows contributors to withdraw approximately around 10,000 ringgit, that's give and take, USD2,500.

So, in terms of liquidity, I think we have really experienced that in the last two years in particular. So, I

think how we balance this is that for the first time in the last two years, we've been very focused on trying to balance from an SAA perspective, this illiquidity risk, as well as how much we expose to the private markets side.

So, in balancing to this, so we have included this into our SAA, given the circumstances that we face, and perhaps we will face in the future. And because of that, our SAA has been crafted as such. Even though I will say in the private markets side, the return has been fairly good with a premium of approximately 400 basis points, on average. We have been relatively fairly conservative in terms of our SAA. So, just to give you some, our current SAA for all the private markets space, real estate, private equity, and infrastructure is less than 10%.

Rohan Singh

Fantastic. And look, I connect-- I'd like to connect your comments back to my opening, where as much as this is about private markets, I wanted us and the audience to remain connected to our sense of purpose. Why are you here to serve your beneficiaries, to serve your constituents. And you've done that yourself and Alaska Permanent in a different way through the pandemic and other periods, and that's why you exist. And that sense of purpose is not lost on us as well, as important partner and service provider to you that the work we do every day, whether we settle trades or prepare valuations et cetera, that at the end of the day, there is a much more important purpose to that. So, thank you for reminding the audience of that.

Frances, I know you've been sitting there patiently. And I'm going to move the conversation a little bit away from investments per se, but more around the challenges that you're seeing as you talk to asset owners, Frances. It could be in the areas of accounting, or performance, or just data aggregation, especially across private and public markets as well. Could you share what asset owners are asking you around the world or sharing some of the challenges with you?

Frances Barney

Thanks, Rohan. So, we've been talking about some of the risks associated with alternative investments, and you can't manage what you can't measure. And the challenge of alternative investments that is different than publicly-traded investments is in the complexity, and the difficulty, and sometimes even accessing the data. And then once you can access the data, what you do with the data is an additional challenge.

So, over the years, as we've seen institutional investors increasing their allocations from, 5% to sometimes 50% of their overall investment programs, we've really seen it increasing challenges with our clients being able to manage the complexity and administration as well as in the management of the data.

So, we've been working to provide additional services related to tracking the investments to supporting the investments, as well as in taking in the data and helping to manage the data. Transparency is a particular challenge with alternative investments, because some institutional alternative managers are not willing to provide the level of detail that institutional investors need. Or if they do provide the detail, it's with customization, it's with unstructured data in a way that makes it difficult for institutional investors to manage the volumes of some of their allocations.

So, increasingly, we're providing support around the data, support around things like ESG data with alternative investments, which is a growing area of concern, as well as information about liquidity risk, and cash flow forecasting, and additional tools and additional types of analysis to help institutional investors deal with the complexities of alternative investments.

Rohan Singh

Thank you. Thank you, Frances. And I just want to continue on that thought. Maybe Marcus, although you're at the front end and on the front office side, clearly it's critical as through your teams, middle and back et cetera, that there's an important ecosystem of providers, custodians, sometimes software providers, et cetera. How important is that construct for you, in terms of operational alpha and investment alpha? And are there further opportunities there that we, as providers for you, can do better for you?

Marcus Frampton

It's a good question. We work very closely with the team of Bank of New York. For example, right now, we're getting all the year-end capital account statements in and it's a real effort to get those on the books so that we can close our numbers and do our reporting. It kind of depends on the asset class we're talking about.

So, absolute return for us, we have 20 managers, it's about 6% of the portfolio. We kind of view the position that we have as the interest with a manager and understanding their strategy. I'm aware of a pure fund with a similar size hedge fund portfolio to us with eight people in hedge funds versus our one, and who's getting-- I'm not sure of all the different vendors or software, but who's getting position-level detail from the hedge fund managers, and cares very deeply about the underlying exposures, how that integrates into the overall fund et cetera. We're kind of like that with our real estate portfolio and our private equity portfolio, because we're so big. And there's a lot of challenges.

I think every year we get a little bit better at really seeing and understanding the underlying exposures, but it's a constant investment of effort and investment of working with partners et cetera. And it just really depends on the asset class. For us, the private areas that are over 10% of the fund, we care tremendously about the underlying positions. And then somewhat arbitrarily, the smaller private asset classes, we're not as focused on it. I'd expect in 10 years, we'll want that same granularity on the smaller ones, but that's not what we're focused on right now.

Rohan Singh

Understood. And Hafiz, similar to you, at a total EPF level, are you comfortable that you have line of sight into a total asset view, which combines public and private markets, whether you want to drill down into country risk or sector risk, irrespective of the asset class? Or like a lot of asset owners, is that work-in-progress towards creating a data model that, not only optimizes investment efficiency, but also risk management?

Mohamad Hafiz Kassim

Thank you, Rohan. This is an excellent question, and I just want to touch on what Frances said earlier just now when it comes to data and reporting.

So, I think private markets, needless to say, there are two key issues that we are facing, and all asset owners are facing, I'm very sure of that. One would be customization of our reporting. Because the way we look at our funds could be different from say, for example, Marcus. Maybe we are a bit more focused on certain areas like turnover at the manager level, which probably certain managers are not really focused on. And I think the other issue will be on the delay of reporting because, as you know, private markets, there's always been a delay -- we've been lucky to get some of the reports, for example quarter four results around this time. So, there'll be a lot of pushing as we try to close our numbers for our annual reporting.

So, I think-- just to answer your question, this is pretty much work-in-progress. Maybe I'll just illustrate an example whereby some of the data that we've been less focused on in the past, and we are becoming increasingly more focused on given the risks that we are looking at, given the circumstances we are in. For example, in the last two years, at the real estate space, we've been a lot more focused on to ensure the collection of our underlying tenants are there. What sort of, I will say, incentives that we need to give to the managers, sorry, to the underlying-- to the tenants?

So, these are the sorts of issues that we are facing, and it's fairly dynamic. And I think from overall perspective, we have-- it's still very much work-in-progress, but I would say at this point of time, we have a good handle in terms of our overall exposure, both from the private market side, as well as the public side.

Rohan Singh

Wow, that was certainly a lot of information to digest there from two very preeminent private market investors and global investors, for that matter. Thank you, Frances, thank you, Marcus, and thank you, Hafiz, not only for your insights, but for the candor. I'm sure our audience would have appreciated that, and there's clearly some valuable learnings from the three of you. I'm sure there'll be some follow-up questions, which we will direct back to you and look to engage with other asset owners as well.

I would also like to thank the audience for listening in. Hope you found the session informative and useful. Before you leave, do check out the latest market insights and thought leadership on the BNY Mellon Asset Owner Academy webpage by scanning the QR code.

Stay tuned for our next webinar, and I hope you have a good day. Thank you all.

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