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NEWS AND VIEWS FOR INSTITUTIONAL INVESTORS

# Private assets and innovative allocation

## Natixis IM Solutions offers multi-asset allocation services including innovative private asset approach to improve portfolio diversification and liquidity

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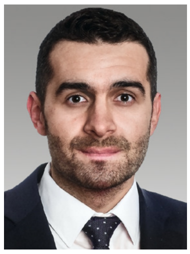

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Long term investors seek to enhance diversification by investing in non-traditional asset classes to better navigate within the phases of economic and business cycles.

This has led investors increasingly to private assets. Done well, a private asset allocation offers inflation protection, diversification benefits , lower volatility, more control over ESG impacts, illiquidity premia and, of course, potential higher returns.

This much is known. Less acknowledged are critical decisions about which private asset classes to select, when to select them and how to efficiently integrate illiquid assets into a portfolio of largely liquid assets.

These decisions will determine whether the introduction of private assets into a traditional portfolio is appropriate or not.

### The questions private asset investors need to ask themselves

An assessment of how a private asset allocation can add value to a portfolio is wider-ranging than many investors realise. And it needs to be truly wide-ranging as investors are committing money for 10-20 years.

A key question, addressed by few investors, is which private asset class offers most value at a given time. The answer to this is critical to the performance of a private asset allocation.

Another question is whether a particular private asset class offers more value versus equivalent public securities. Even if investors ask themselves the question, they may not be in a position to answer it.

Once investors establish that it is an opportune moment to invest in a particular private asset class versus its public equivalent, investors need to assess which specific funds are likely to outperform and whether they can actually access those funds.

After that, investors face the task of building a private asset portfolio that is genuinely diversified across private asset classes over time. This portfolio must be structured to respond to the target risk levels of investors, investment horizon and their individual liquidity needs.

### Which private asset class and when?

So how might an investor creating a private assets portfolio allocate between real estate, infrastructure, private equity and private debt?

The answer is almost certainly not one quarter, one quarter, one quarter, one quarter. Expected returns from each of these private asset classes vary widely depending on when the allocation is made.

## Key takeaways:

- In building a private asset portfolio, considering the position in the economic and business cycle completes the relative value analysis.
- To be genuinely useful, analysis should compare the attractiveness of private markets vs public markets. It should also assess which private asset class will outperform, before finally comparing and selecting private assets themselves, with a focus on ESG dimensions.
- For investors investing in both liquid and illiquid markets, a relative approach can help better design their private asset pockets within their entire portfolio.

"We are multi asset allocators so we come to private assets from a different direction to private asset managers who invest only in a single asset class," says Philippe Faget, multi and private asset portfolio manager at Natixis Investment Managers (Natixis IM) Solutions. "We invest in multi-private assets and perform relative analysis and valuation".

"Put simply, depending on our macro-economic views we generate convictions on the different private asset classes and their sub-strategies."

Some characteristics are common to all illiquid assets, but there are also specificities within them that change their relationship relative to other illiquid assets.

"Illiquidity gives you a premium, but how much depends on the entry point, at which phase of the business cycle we are and hence, of the vintage year," says Faget.

As can be seen below, the blue line represents the evolution of the median net Internal Rate of Return (IRR) of European private equity funds depending on their vintage. An investor allocating to private equity in 2006, before the Great Financial Crisis, would have seen an IRR around 8%.

That is, generally speaking, a satisfactory level of return. However, investors allocating after the GFC vintages would have been rewarded with nearly double that level of IRR.

Faget says: "It shows the sensitivity of private assets to the business cycle. The entry point is very important: you need to know where you are in the economic cycle, which is why we have an experienced team focused on developing forward-looking economic views."

## Why it is necessary to consider return dispersion of private asset funds

Only once it is established which private asset classes to invest in, it is time to select individual assets. Private assets are notoriously complex to assess and access.

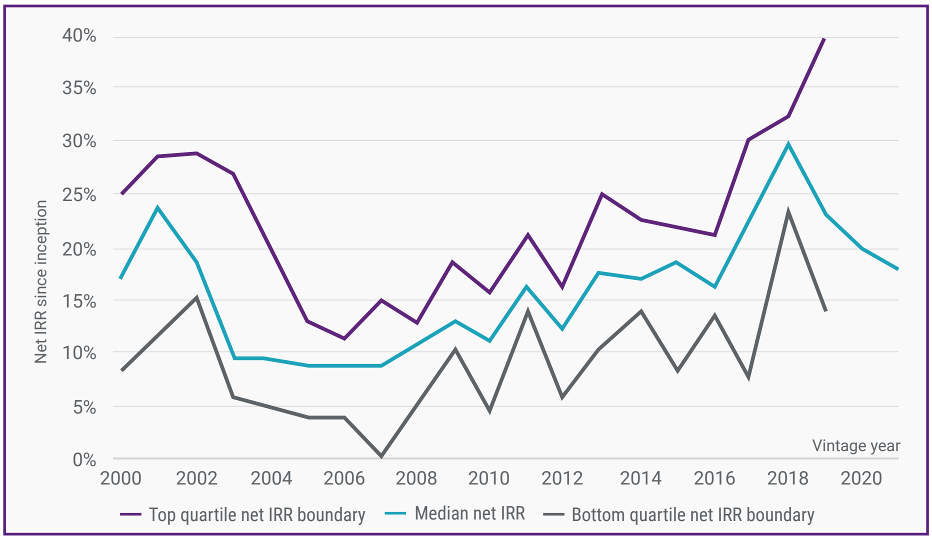
While the availability of data has improved over past years, it remains challenging, especially for some granular modelling. "We have developed proprietary models in order to better assess the specific characteristics of private assets" says Joseph Gawer, financial engineer in multi and private assets solutions at Natixis IM Solutions.

Private assets are valued infrequently. Investors require a coherent risk measure across both their public and private investment, but specific pricing dampens traditional risk measures such as volatility. In addition, illiquidity risk is hard to manage because there is limited ability to rebalance portfolios. The recent development of secondary markets could mitigate that in the future.

Managing commitments, capital calls and distributions are crucial in managing multi asset portfolios and could generate additional value creation. Ramp-up dimension could be as well mitigated by using different approaches (strategies diversification, secondary, co-investments, active public asset management, etc.).

In the graph, the difference between the top and bottom quartile private equity performance of European funds can be seen to be substantial and persistent over time.

**Internal Rate of Return (IRR) of European private equity funds**




*Source : Cambridge Associates as of* Q2 2022, NIM Solutions

"The gap between the best funds and the others is not that large in public markets, but it's very sizeable in private markets," says Faget. "This means the knowledge and experience of asset allocators, and the depth of their networks is very important in the private markets world."

## Evaluating private vs public markets

The final part of the jigsaw is tailoring the multi-private asset portfolio to specific investor needs. These needs often include how to integrate the private asset pocket of a portfolio within an existing portfolio of publicly-traded securities.

"When building private assets pockets, we find investors want to work with a firm that understands their current portfolio, which tends to be highly liquid," Faget says. "We are one of the few global allocators with the ability to analyse relative values both within private assets and between private and public markets."

Natixis IM Solutions uses a risk premia approach to ensure consistent modelling between public and private markets. Its teams also develop forward-looking views on both public and private assets.

The team has direct access to all Natixis IM affiliates, trading both public equity and debt and covering a wide range of private asset classes and geographies.

Faget says: "We are affiliate-neutral and just select the best strategies – whether in public or private markets – using our experience in asset allocation and our ability to navigate across all asset classes."

## Tailored liquidity

The multi-asset approach allows Natixis IM Solutions to build in sufficient liquidity for each investor's profile and constraints.

"We can design liquidity, for both open and closed end structures," says Gawer.

Solutions can be designed with various liquidity mechanisms such as exit windows, or by investing in secondary funds, which flatten the J-curve.

Other liquidity-enhancing approaches include co-investments and arbitrage between the opening and closing periods of funds.

"The Natixis IM affiliates are usually willing and able to create dedicated mandates with various levels of liquidity for clients of Natixis IM Solutions," says Gawer. "We model liquidity, stress-test extreme market scenarios and make sure liquidity mechanisms and cushions are in place where needed."

Natixis IM Solutions has a proprietary ESG qualitative and quantitative process to assess ESG factors for both public and private assets. Depending on the level of client's ESG appetite, different solutions can be designed.

The ESG process consists of an independent review of the expertise and ESG processes of Natixis IM affiliates. All Natixis IM affiliates specializing in private assets are signatories to the United Nations Principles for Responsible Investment (UNPRI).

"We focus heavily on how our affiliates are be able to articulate their ESG-related conviction " says Gawer. "We want to assess the degree to which ESG factors play a meaningful role in the investment strategy."

## Conclusion: private assets and innovative allocation

In building a private asset portfolio, the analysis of the position in the economic and business cycle completes the relative value analysis.

To be genuinely useful, analysis should compare the attractiveness of private markets vs public markets. It should also assess which private asset class will outperform and at what time, before finally comparing and selecting private asset classes and strategies themselves.

Faget says: "For investors investing in both liquid and illiquid markets, our relative approach including macro-enconomic views helps better design private asset pockets within a diversified portfolio."

"In this sense, how we view our job as a provider of innovative private asset solutions is probably a bit different from most."

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