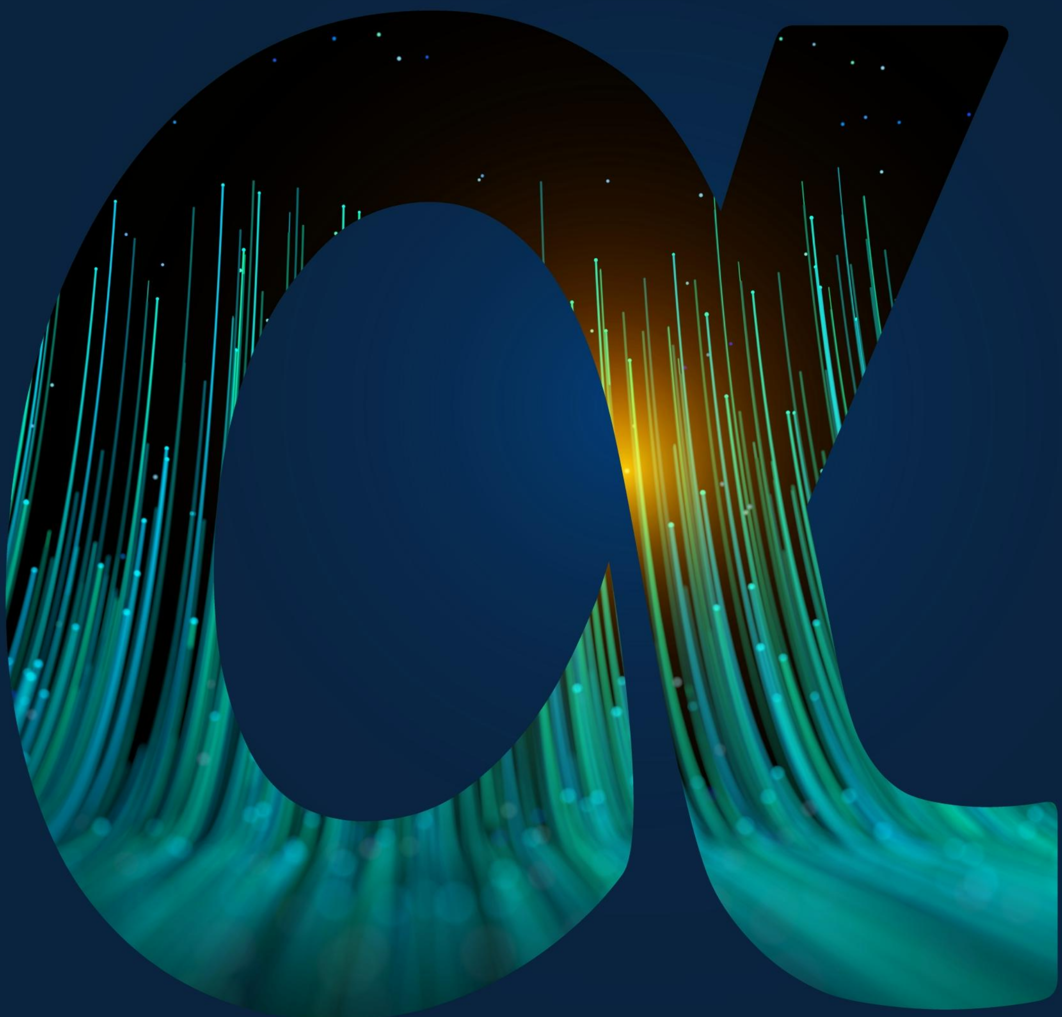
State Street Alpha℠

What's driving asset manager and asset owner appetite for private markets?

State Street Alpha Private Markets Survey Report



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Executive summary

- Mainstream assets have not always successfully fulfilled traditional roles in investors' portfolios for several years
- Private market assets are expected to grow to $14.4 trillion by 2025, with significant growth in private equity[1], private credit, and infrastructure
- Asset managers and asset owners expect to increase allocations to private market assets to 35% and 28% of their total portfolios, respectively, over the next three-to-five years
- More than half of respondents plan to increase their allocation to private equity, private debt and infrastructure, while real estate (already more established in portfolios) appetite lags behind
- Diversification and better returns are the top drivers for private market investment for both asset owners and managers
- EMEA asset owners plan to invest more in private equity; North American counterparts favour private debt
- High or unclear fees, illiquidity, overcrowding, and complex or opaque fund structures are among the main deterrents for asset owners
- Managers need to improve the availability of ESG options and data to attract new money

[1] State Street Alpha Private Markets Survey, 2021

Introduction

Private markets to benefit from increased allocations.

There has been a growing sense among asset managers and owners that public market assets are not always enough in their traditional roles as diversifiers, drivers of growth and income generators.

The low interest rate environment in place since the Global Financial Crisis has changed investors' relationships with public markets and the Covid-19 pandemic has only added uncertainty and contributed to higher volatility.

These conditions have driven considerable institutional investor interest in private markets in recent years, and many have sought new asset classes to enhance in their portfolios vacated by overvalued public assets.

Continued interest and increasing familiarity mean that more capital is likely to flow into the private asset class in the coming years. Consultancy PwC predicts the private markets industry will grow $4.9 trillion to $14.4 trillion by 2025, in its base-case scenario.[2] While private equity will continue to dominate, there will be significant increases in the other private market subsegment of infrastructure, real estate, and private credit.

To find out more about what is driving allocations to private markets, State Street conducted two related surveys. The first investigated the views of 85 asset owners in North America and EMEA. The second explored the views of 85 asset managers based in North America, Europe and Japan. Both took place during August and September 2021.

Consultancy PwC predicts the private markets industry will grow $4.9 trillion to $14.4 trillion by 2025, in its base-case scenario.

[2] https://www.pwc.com/gx/en/private-equity/assets/pwc-prime-time-for-private-markets-2021.pdf

Allocations now and in the future

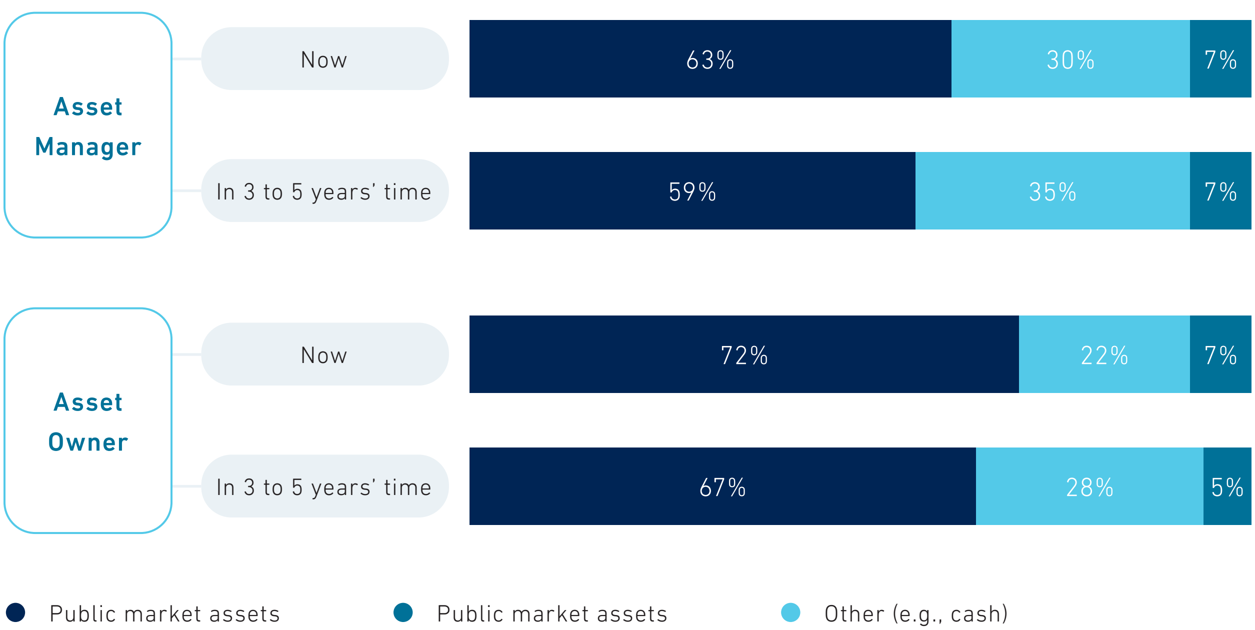
Public market assets make up the majority of asset manager and asset owner portfolios for several reasons. Greater capacity, liquidity, transparency and frequent pricing are very real advantages that listed equities and core fixed income have over private market assets.

Although private market assets make up a relatively minor part of portfolios, both asset managers and asset owners are expecting to allocate more to the sector next few years.

Allocations to private market assets are set to rise further

Both asset managers and asset owners expect private market assets to take a bigger slice of their overall portfolios, rising to over a third of total assets under management (35%) at asset managers, and over a quarter of total assets under management (28%) at asset owners in the relatively near future.

Portfolio share: private v public market assets



Data may not sum to 100% due to rounding

Q: For assets under management at your organization, what is the approximate split of public market assets and private market assets now and what do you expect it to be in three to five years' time?

Our asset owner respondents have 22% of their portfolios invested in private markets, although they expect this to rise to 28% over the next three-to-five years. In anticipation of this demand, asset managers expect still greater exposure, holding around 30% of assets under management (AuM) in private market assets. They also envisage this rising, to 35% in the next three-to-five years, so their relative exposure to public markets will fall.

Asset owners and managers, as to be expected given their provider-client relationships, have broadly similar reasons for increasing private market as a proportion of their portfolios, with both sets of respondents highlighting diversification and better opportunities for returns as the most important driver. However, asset managers put more weight than asset owners on the attractive yields available in the private markets space.

Respondents in each region had different reasons for investing in private markets. EMEA respondents put a greater emphasis on the ESG, sustainability and impact investing attributes of private markets. They also put greater weight on inflation protection. Meanwhile, North American respondents put greater emphasis on opportunities for return generation.

A strong mix of attributes are driving growth in private markets investing

Managers and owners have very similar views on the key drivers for private markets, with diversification and better return opportunities leading the way. One difference is that managers put more weight on attractive returns.

Asset Manager		Asset Owner
59%	Diversification from listed markets	67%
52%	Best opportunities for return generation	52%
27%	High valuation in public markets forcing investors to look elsewhere for value	29%
24%	ESG/sustainability/impact investing opportunities	29%
40%	Attractive and/or stable income/yield	28%
17%	The trend for companies to remain private for longer, resulting in a rising share of national GDP in the private markets in the economy	20%
20%	Inflation protection	19%
18%	Low volatility	18%
15%	Opportunity to finance and/or own infrastructure assets	15%

% Yes, Multiple answers allowed

Q: What do you see as the key drivers for future growth in private markets investing? Please select at most 3 answers.

The view on the ground: Asset owners

Our research found just over half of asset owners planned to increase their allocations each of private equity, private credit, and infrastructure over the next three-to-five years.

With valuations at high levels, there may be limited further upside for listed equity – particularly as the Federal Reserve is expected to start a rate tightening cycle. Institutional investors may opt to increase their allocations to private equity to help them hit their return targets.

Higher inflation is prompting central banks to tighten monetary policy, first by scaling back quantitative easing. This could signal the end of the low-rate conditions established after the Global Financial Crisis, designed to stimulate economic recovery and later maintain growth with low borrowing costs.

For many asset owners, private markets allocations are set to rise

Nearly half of asset owners plan to increase allocations to private equity, private debt and infrastructure in the next few years. For real estate, just over a third (35%) plan to allocate more, while 15% plan to cut real estate.

	Current allocation (% of total AUM) e.g., the percentage of overall asset allocation held in that private market	In 3 to 5 years' time, will this allocation... Decrease	Unchanged	Increase
Private equity	8.5%	8%	37%	55%
Real estate	7.2%	15%	49%	35%
Private debt	4.3%	6%	40%	54%
Infrastructure	3.1%	6%	41%	53%

Data may not sum to 100% due to rounding

Q: Within private markets, what is your organization's allocation* to each of the following private markets and how do you expect it change in three to five years from now? (Asset Owner)

While rates will likely rise from ultra-low levels they are unlikely to very much, so investors will still need higher yields for their income requirements, fuelling demand for private credit. In addition, in a higher inflation environment, investors will also likely seek out assets such as infrastructure that offer a significant degree of protection against rising prices.

Conversely, real estate appeared to be asset owners' least favoured private sub-class; just 35% of respondents are planning to increase allocations while 15% say they will cut their exposure in the coming years.

Institutional investors are generally very familiar with real estate, but the sub-class has struggled during the pandemic. Parts of the real estate market are facing considerable challenges; for example, retail has been challenged by online retailers while prolonged adoption of 'work from home' would impact the long-term fortunes of the office sector.

The research also highlighted several regional differences between private market allocations.

The most popular sub-class among EMEA asset owners is private equity, representing 9% of portfolios. The majority (60%) plan to increase their exposure, a greater proportion than for any other private market sub-class.

By comparison, from North Americans' average portfolio allocations of 7.8%, just 47% of asset owners plan to increase their exposure and 16% plan to reduce exposure.

Signs of a transatlantic split over private equity allocations

European asset owners are much more likely to raise their private equity allocation, while North American asset owners are more likely to boost their private debt allocation. North American asset owners already hold more in real estate and infrastructure and plan to increase by more than their peers in Europe.

	North America				EMEA			
	Organization allocation	Decrease	Unchanged	Increase	Organization allocation	Decrease	Unchanged	Increase
Private equity	7.8%	16%	38%	47%	9%	4%	36%	60%
Private debt	4.2%	3%	38%	59%	4.6%	8%	40%	52%
Real estate	8.5%	6%	63%	31%	6.6%	18%	42%	40%
Infrastructure	4.4%		44%	56%	2.4%	10%	36%	54%

Data may not sum to 100% due to rounding

Q: Within private markets, what is your organisation's allocation*, as a % of your total assets under management, to each of the following private markets? (Asset Owner)

North American asset owners made their largest private market allocations to real estate, making up 8.5% of portfolios. However, just 31% plan on increasing exposure – the lowest of all private market sub-classes.

For respondents outside North America, real estate is the area they are least likely to make future allocations; from of 6.6% of portfolio assets, just 40% plan to increase allocations and 18% were planning to cut exposure.

North American asset owners had their largest allocations to private debt and infrastructure with allocations of 4.2% and 4.4% respectively, with 59% and 56% planning to increase exposure.

While EMEA asset owners allocated just 2.4% of AuM to infrastructure, 54% plan to increase weightings while 10% plan to cut allocations.

Asset owners considered all four sub-classes to have two key attributes: they are seen as diversifiers from public markets and have a long-term focus. However, respondents considered each sub-class to possess other different strengths.

Private equity, for example, was considered to have better potential for capital growth and alpha than the other sub-classes, although fewer respondents believed it offers diversification from listed markets. Most respondents believed private credit offered attractive yields and the most diversification from listed markets, although fewer thought it had a long-term focus. Real estate scored highly for inflation protection and more asset owners thought infrastructure had a longer-term focus than any other sub-class.

Owners on the main attributes of different private market assets

- While all four private market assets are seen as diversifying and having a long-term focus, other attributes vary between them, with income generation important for all but private equity, which gives capital growth instead.
- Private equity and debt offer alpha potential, while real estate and infrastructure give inflation protection.

	Private equity	Private debt	Real estate	Infrastructure
Potential for capital growth	91%			
Potential for alpha/added value	68%	40%		
Long-term focus	42%	33%	53%	60%
Diversification from listed markets	39%	72%	61%	62%
Attractive yield/income generation		84%	47%	48%
Inflation protection			64%	42%

% Yes, Multiple answers allowed

Q: What do you see the most important investment attributes for private market assets? (Asset Owner)

The view on the ground: Asset managers

Private equity and real estate are the most common type of private markets strategy offered by asset managers, with 75% of our respondents operating funds investing in these areas.

Offered by 69% of asset managers, private debt is the strategy with the highest average AuM at $13.2 billion. This suggests strong demand for an alternative to corporate and public debt markets where yields are lower.

Infrastructure, offered by 59% of asset manager respondents, is currently a more niche play with an average of $4.6 billion in AuM.

Managers have seen high inflows to private debt funds

Private equity and real estate are widely offered, by 75% of asset managers, with an average of 12 funds per manager. Despite being offered by fewer managers (62%), private debt has the highest approximate AUM ($13.2bn) at managers, showing the high demand for an alternative to low yields on core fixed income.

	Asset Manager	Approximate AUM ($bn)	Number of funds
Private equity	75%	11.5	12
Real estate	75%	12.9	12
Private debt	62%	13.2	6
Infrastructure	59%	4.6	6

%Yes, multiple answers allowed

Note: Manager respondents were asked for their approximate AUM managed and the number of different funds they run for each category of private markets, with the average figures for approximate AUM and number of funds shown here.

Q: What private market investments do you offer to investors? Please indicate if you offer each the following categories of private market, approximately how much is managed and the number of different funds.

Total private debt AuM in North America was estimated at $506 billion in 2020, according to alternative investments data provider Preqin, compared with $259 billion for Europe[3]. The strategy has been widely adopted by North American asset managers, being offered by 79% of respondents, with average AuM of $17.9 billion. In Europe, the strategy is less mainstream, being offered by 54% of asset manager respondents with an average AuM of $5.2bn.

The most common private market strategy in Europe is real estate, offered by 77% of respondents. The region is also a leader in infrastructure, with 64% of asset managers active in the space, compared with just 48% of North American respondents.

Asset managers foresee all distribution channels playing a role in the distribution of private markets strategies going forward. More than two-thirds of asset managers (69%) predict that wealth managers will remain the primary channel for the distribution of private markets strategies in five years' time.

Around half of the respondents expect the wholesale channel will grow in significance. Over the same period, asset managers expect fintech providers to soar in importance as a new distribution channel.

In terms of their investor base for privates, asset managers in North America predict endowments & foundations will overtake defined benefit pensions schemes as the largest investor group in private market strategies.

79%

of asset managers offered a private debt that is most prevalent in North America with average AuM of $17.9bn.

54%

of asset manager respondents offered the sub-class in Europe with an average AuM of $5.2bn.

[3] https://www.preqin.com/insights/research/reports/preqin-special-report-the-future-of-alternatives-2025

What's holding private market assets back?

There is a widespread expectation that private market assets will see a significant uptick in inflows during the next five years. Growing AuM in privates is unlikely to come without its challenges.

The perception of high and/or unclear fee structures is the most significant barrier facing asset owners contemplating investing in private assets, as cited by 38% of global respondents. The issue is particularly acute for North American respondents, with 59% flagging it as an issue.

Another significant concern for North American asset owners is overcrowding in attractive assets, reducing the potential for alpha; this was highlighted by 35% of respondents. Complex or opaque product and fund structures were also a concern for 31% of North American asset owners.

Barriers to private market vary by region and owner type

High or unclear fee structures are a bigger barrier for North American investors and institutional investors.

	Global	North America	EMEA	Institutional Investors	Other Investors*
High or unclear fee structures	38%	59%	26%	44%	27%
Illiquid nature (capture tied up for long periods)	35%	25%	40%	35%	37%
Overcrowding in attractive assets reducing alpha	35%	44%	32%	40%	27%
Complex or opaque product/fund structures	31%	31%	32%	27%	37%
Resistance from board members and/or senior staff	18%	13%	22%	20%	13%
Lack of information on ESG criteria	15%	9%	20%	16%	13%

Outside of North America, the oft-required tying-up of capital for multi-year periods is the biggest barriers to investment in private markets, highlighted by 40% of the region's asset owners.

Complex and opaque fund structures were also a concern for 32% of EMEA asset owners; the same percentage cited resistance from board members or senior staff as inhibiting investment.

Asset managers highlighted a different range of challenges as headwinds to the future growth of AuM in private markets funds. Poor accounting and audit controls was cited as having the most negative impact on the industry, flagged by 64% of asset managers.

High management fees versus public markets – as highlighted above by asset owners – and a lack of uniform data standards were also seen as potential barriers to growth in privates AuM.

Better data, bigger asset pools and ESG could all boost private markets

Better quantitative data could boost private markets investing, along with ESG-friendly investments and investment pooling. Poor accounting and audit controls, high fees and a lack of data standards are negatives.

	Negative impact	Neutral	Positive impact
Weak standards of accounting and audit controls over private market assets	64%	33%	4%
High management fees relative to public markets	60%	31%	10%
Lack of uniform data standards	58%	38%	5%
The increasing number of players in the most popular areas of private markets	38%	33%	30%
Regulatory requirement on asset managers and investors	28%	34%	38%
Use of tokenization (digital tokens) to make private market investing accessible to a wider range of investors	26%	51%	24%

Notwithstanding these challenges, the industry is finding new routes to attract further inflows to private markets. For example, ESG in private markets is an increasingly important theme. More than three-quarters of asset managers (78%) report rising investor demand for private market assets that make a positive and measurable contribution to sustainability or other ESG criteria.

On the supply side, ESG is a significant issue for global asset owners, although two-thirds complained that a lack of common ESG data standards makes it hard to compare different investments and assess performance.

Another idea to increase the AuM in private markets centres on investment pooling and fund consolidation to create larger entities with a greater ability to hold illiquid assets. Availability of more timely and accurate quantitative data for investors would also underpin an increase in demand for privates.

In the evolving digital space, there was no consensus among our respondents over whether digital tokenisation would positively or negatively impact private markets.

Conclusion

There is undoubtedly increasing enthusiasm for private markets assets from an asset owner and therefore asset manager standpoint. A greater understanding of what private market assets can bring to a portfolio is moving privates into the mainstream. New opportunities, such as an increased appetite for ESG-friendly assets, could also drive further inflows to the asset class.

However, there are some challenges to the broader appeal of private assets. More education on fund structures, liquidity, and pricing could help break down barriers for some potential investors. Private-held companies/structures could also play a role by improving their accounting and audit controls. Meanwhile, increased competition among asset managers and the potential entry of retail investors into privates may see today's premium management fees come down.

At State Street, we have 20 years of institutional knowledge, a comprehensive suite of services and next-generation digital technology. As such, we can help asset owners and managers capitalise on the rapid growth of private market assets.

Our Alpha for Private Markets platform harmonises data and provides a complete view of the investment lifecycle, enabling, inter alia, a single version of the truth for PMs and investors, provides a unified portfolio view across public and private assets and allows rapid responses to investor demands. It's integrated and it's interoperable.

With interest in private markets unlikely to disappear anytime soon, it is vital asset managers put in place the right infrastructure to scale their operations and make the most of the undoubted opportunity in privates.

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State Street Corporation
One Lincoln Street, Boston, MA 02111

www.statestreet.com

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