



Private Market Alternatives

Are they worth it and what's the best way to gain access?

October 2016

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Executive Summary

KPMG Investment Advisory View

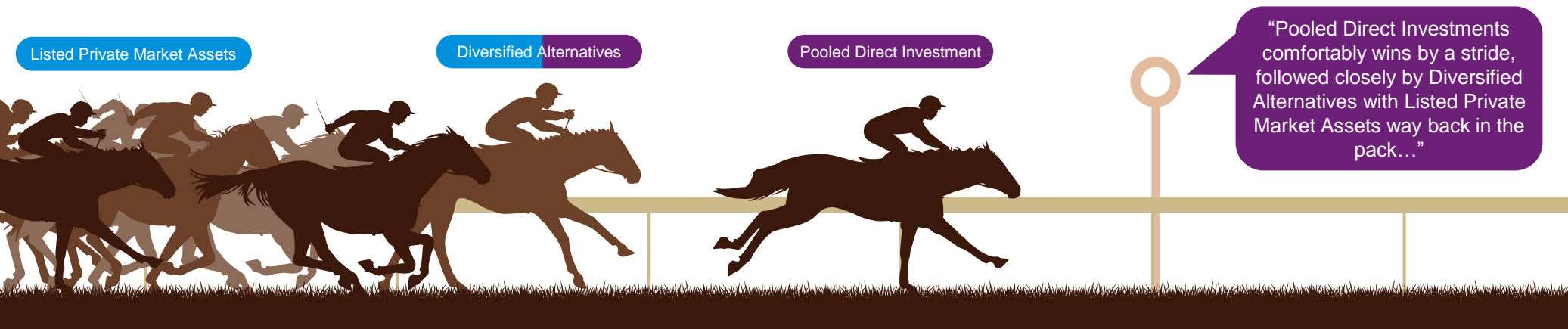
We recommend that clients speak with their Consultant to consider whether an investment in a diversified alternatives fund or a pooled long lease property fund would be beneficial for the scheme.

We believe private market assets are an attractive proposition for pension schemes due to the potential for higher return and the diversification benefits.

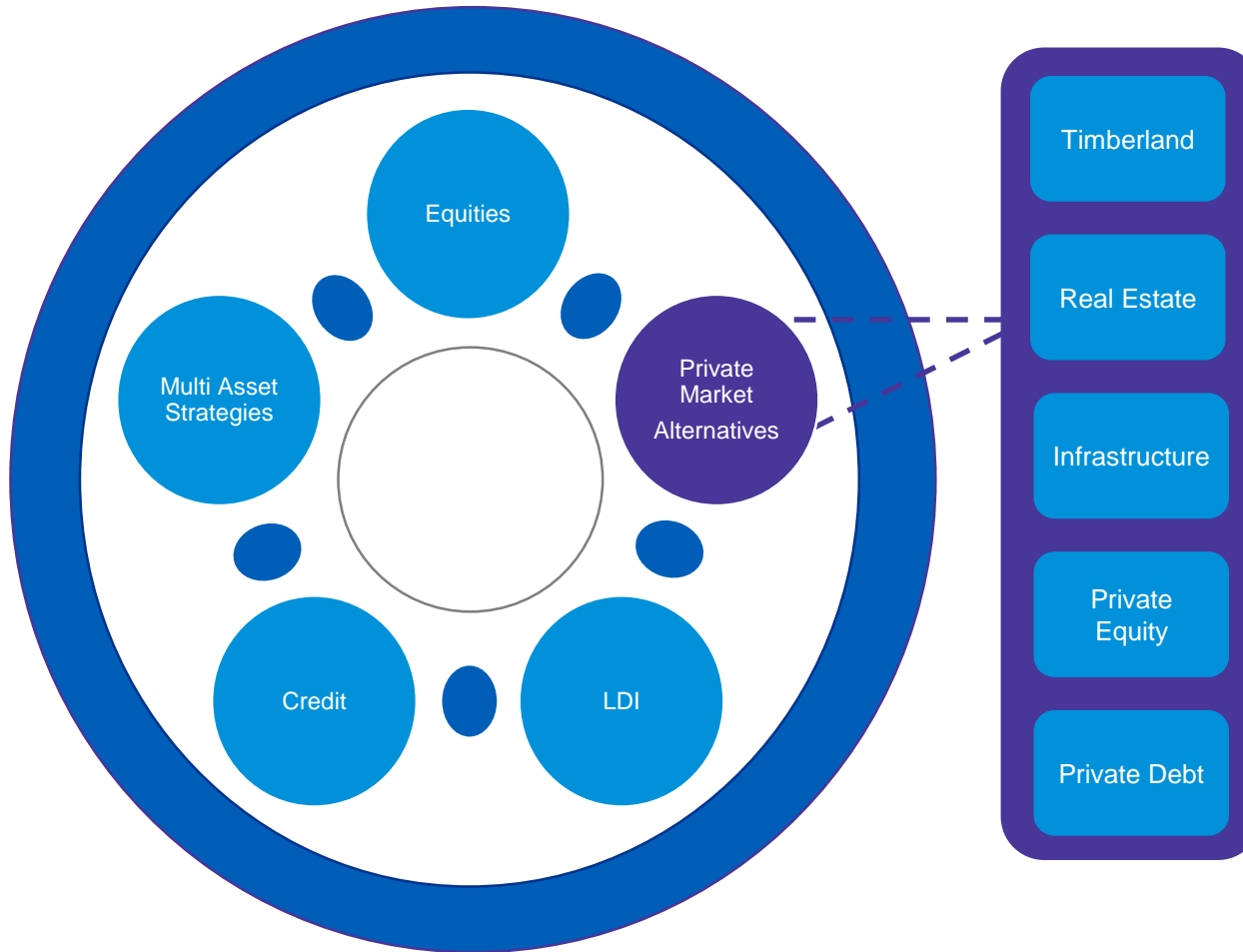
Our preferred method for investing in private market assets is through pooled funds which make direct investments – we believe if schemes are comfortable with the additional governance and illiquidity, they will be best served by direct investments.

We do not believe listed private market assets provide a compelling substitute for direct investments for the reasons explained in this paper.

Our view is that if direct investments are not a feasible option for some schemes, the next most effective way of accessing private market assets is through a diversified alternatives fund. These funds are single pooled vehicles that invest in a mix of private market strategies such as Private Equity, Private Debt, Private Real Estate and Infrastructure – but do so in a way that mitigates most of the barriers associated with direct investments.



What are alternative assets and why are they attractive?

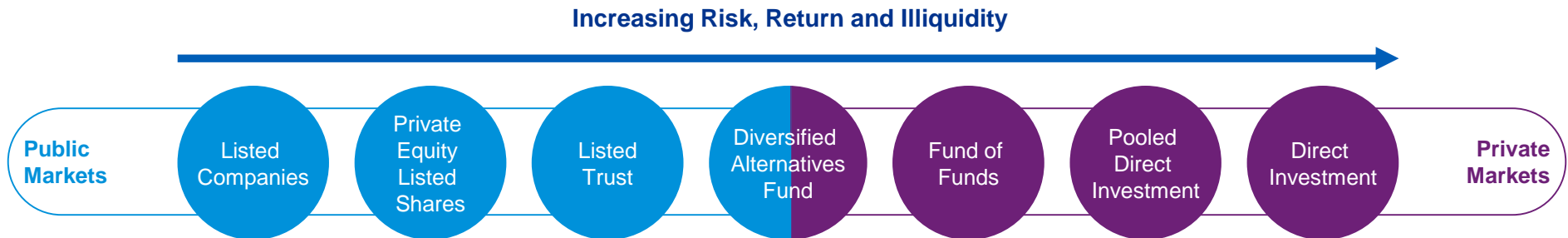


Alternative assets – Why are they attractive?

- **Alternative return drivers** – the underlying drivers of returns are not dependent on simply improving financial ratios or trying to spot differences in prices between one market and another. Rather, asset improvements are made to generate returns (e.g. improving a company's operations for Private Equity or planting the most cost effective tree for Timberland).
- **Illiquidity premium** – alternative investments are often long-term in nature, and the funds have long lock-up periods. Investors are rewarded for this illiquidity, and pension schemes with long dated benefit obligations are well placed to afford such illiquidity.
- **Diversification benefits** – we believe there are alternative assets (e.g. insurance linked securities) that have fundamentally unique underlying drivers of return that are not correlated to financial markets – *thus bringing true diversification*.
- **More control over the assets** – whilst active and passive management readily exists for traditional assets, alternative investments are rarely available in the passive form.
- **Long dated cashflows** – a number of alternative asset classes (e.g. infrastructure and long lease property) offer natural liability matching income streams for pension schemes as the assets generate relatively stable and inflation linked cashflows.

Private Market Alternatives – Are they worth it and what's the best way to gain access?

How can investors gain exposure to alternative assets?



How can alternative assets be accessed?

In the past, institutional investors (such as pension schemes) have predominately accessed 'alternatives' through **pooled direct investments – which often take the form of closed-end limited partnerships.**

Whilst this is our preferred access route, allowing investors to capture the benefits of alternative investments fully, there are considerations with this access method:

- **Increased governance** – a high proportion of investments require funds to be drawn down over a period of time as opportunities are identified. In addition, investors often need to recommit to funds to maintain exposure.
- **Illiquidity** – pooled direct funds typically have long lock-up periods, which can be as long as ten or fifteen years depending on the underlying asset class.
- **Manager access** – experienced and well resourced managers are in high demand, and are very often oversubscribed. This means it can be difficult for new investors to gain access to 'top quartile' managers.

As a result of the above, private market alternatives have traditionally been limited to larger investors who have the governance and illiquidity budgets to make a meaningful commitment to alternative assets.

How can investors gain exposure to alternative assets? (cont.)

Is there an alternative to pooled direct investment?

More recently we have seen a renewed interest in '**listed**' alternatives, with a number of managers actively marketing new or existing products.

But what constitutes a 'listed' alternative investment? We summarise a number of potential definitions below:

1. **Access via a Listed Company** – in its simplest form, an investor could gain exposure to an alternative asset class by purchasing the shares of a listed company in a related industry. Take an investor looking to gain exposure to property – they could buy 100 shares of Taylor Wimpey, one of the largest house building companies in the UK. The rationale here is that when property prices increase, this should be reflected in Taylor Wimpey's profit and the shares of Taylor Wimpey could increase in value as a result.
2. **Access via a Sector Focused Fund** – instead of buying shares in a single company as per Option 1, an investor could access a passive or actively managed sector focussed fund. Such funds only invest in shares of companies operating in a particular sector e.g. infrastructure or property.
3. **Access via a Listed Mutual Fund** – rather than purchase listed securities, investors can purchase shares in mutual funds that make illiquid investments, but are actively traded on an exchange – e.g. REITS or Listed Private Equity Companies. In this case, the listed fund purchases a portfolio of private assets and manages them in the same way that a direct manager would.

The rest of this paper focuses on whether or not these access routes are an effective way for pension scheme to access alternative investments – **spoiler alert, we think not.**



Private Market Alternatives – Are they worth it and what's the best way to gain access?

Should pension schemes consider these listed access routes?

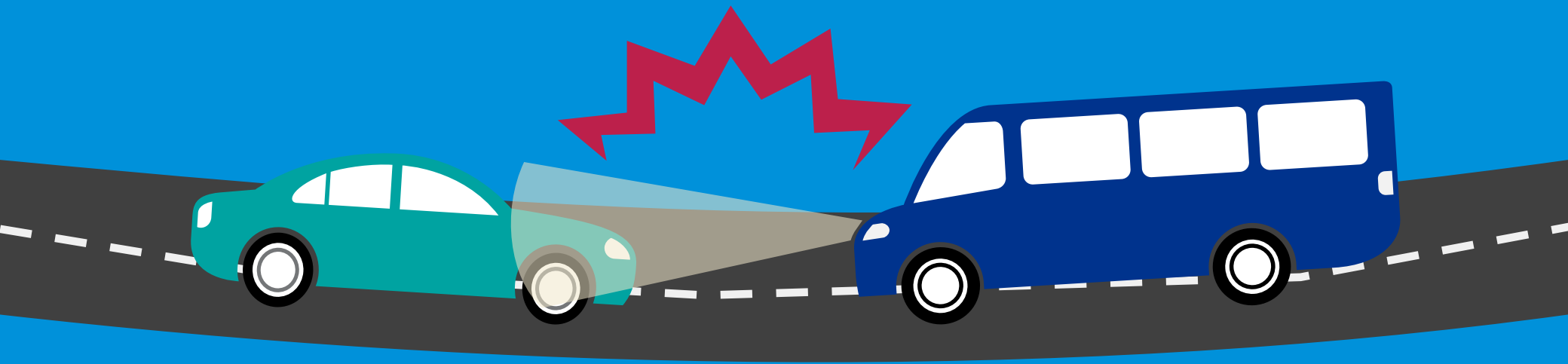
A valid substitute?

We don't think so!

Although on the surface these access routes may appear to mitigate the issues of governance, illiquidity and manager access with direct investments highlighted earlier, our research has shown that in practice this is not the case.

In particular, we conclude that listed private market assets:

- **Offer limited diversification benefits** – Although there may be some correlation to the underlying markets over the longer term, listed private market assets are highly correlated to equity markets in the short to medium term. In fact, listed private market assets tend to become highly correlated to financial markets in times of stress - the periods when the benefits of diversification bring the greatest value!
- **Aren't as liquid or transparent as they suggest** – and as a result can trade at a discount to NAV for long periods of time.
- **Can expose investors to an additional layer of fees** – and there are potentially large bid/offer spreads when trading.
- **Make accessing the best opportunities more difficult** – as portfolio allocation and discretion of which opportunities to invest in lie solely with the manager.



Considerations of Listed Alternatives

Diversification Benefits

As previously mentioned, we believe alternative investments can offer true diversification benefit to a portfolio by providing access to unique drivers of risk and return (not found in public markets).

We don't believe this holds true for listed alternatives.

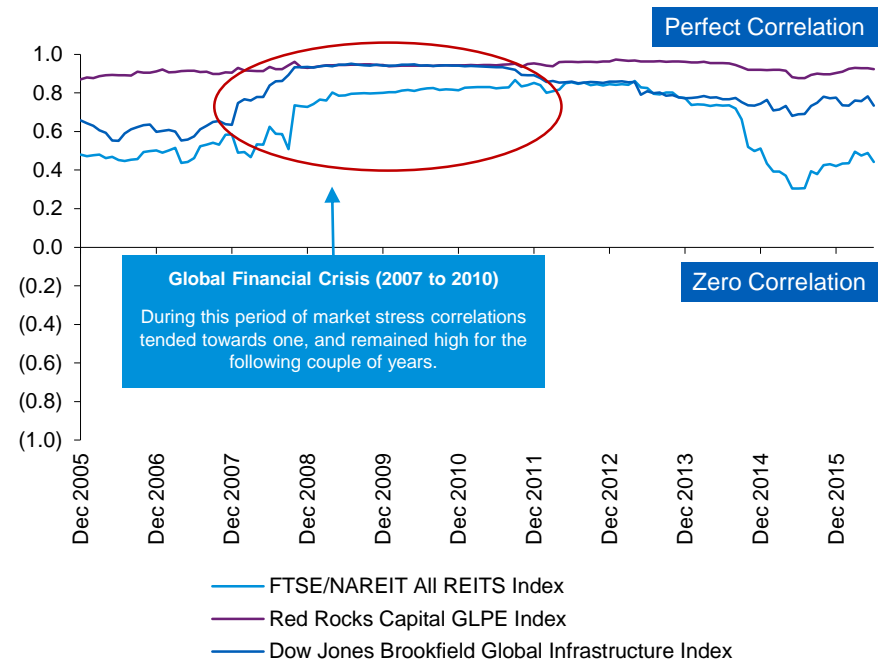
While we are not saying these investments offer zero diversification benefit, our view is that these vehicles tend to follow public market volatility and return patterns, especially in periods of market stress, rather than the returns of the underlying private investments.

Take Listed Private Equity ("LPE") in particular, an example of a sector focussed fund (Option 2). This is where an investor purchases shares of listed private equity companies (e.g. 3i Group, Blackstone, KKR). If the private equity company invests in good projects which generate high returns, this will be reflected in the fees they receive and in turn the share price of the company should increase. However, it is clear to us that this relationship does not hold true – instead, returns are heavily influenced by public market sentiment rather than the private equity company's ability to generate returns.

To evidence this relationship, we graph three year rolling correlations between the returns of the MSCI World Index (Global Equity) and a handful of listed alternative indexes. We find:

- Correlations between global equity markets and listed vehicles are predominately positive and track above 0.6 for long periods of time.
- Ten year correlations are positive across all three selected comparators and tend towards one (significantly high correlation) for both North America REITS and Dow Jones Brookfield Global Infrastructure.

3 Year Rolling Correlation to MSCI World



10 Year Correlation to MSCI World

Index Comparison	Correlation
FTSE/NAREIT All REITS Index	0.75
Red Rocks Capital Global Listed Private Equity Index	0.94
Dow Jones Brookfield Global Infrastructure Index	0.87

Note: Indices used are Total Return, and US Dollar denominated.

Sources: Red Rocks Capital, Thomson Reuters EIKON, Bloomberg, KPMG Calculations.

Considerations of Listed Alternatives (cont.)

In fact, as the chart opposite shows, listed private equity companies (represented by the Red Rocks index) lagged private equity returns by a long margin, providing returns closer to equity indices.

The same is true for listed companies or listed mutual funds in the private equity, infrastructure or property sectors.

Pricing

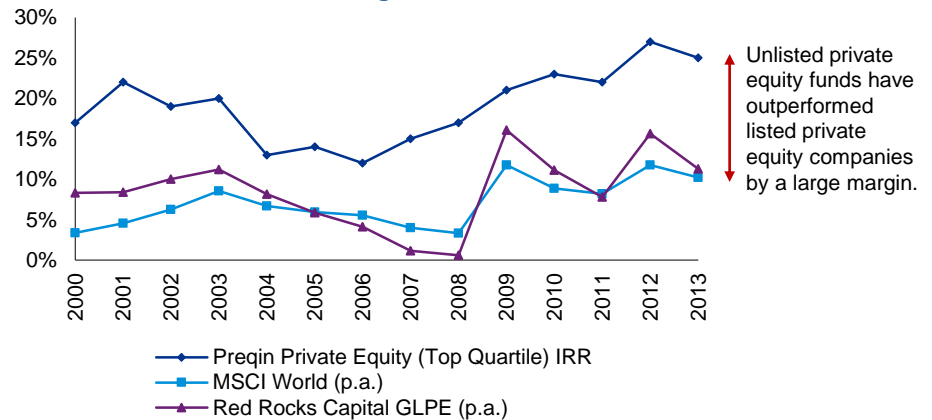
The pricing relationship between public and private markets varies significantly over time. In REIT and LPE markets in particular, large discounts have been a persistent feature of the last decade due to a number of reasons:

- Fund shares are less liquid than other stocks;
- They are less transparent than other public listed companies;
- The manager may hold either a large amount of cash or use a credit facility to manage investments;
- Investors typically sell listed holdings before unlisted ones, if they require liquidity.

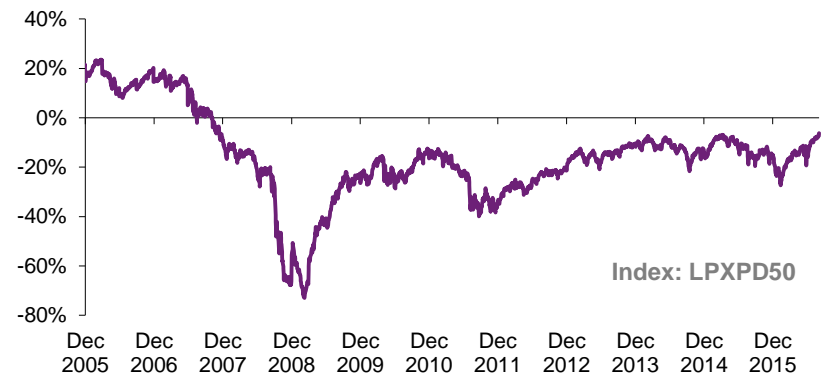
As the chart opposite illustrates, most LPE funds trade at a discount. Since 2008 (when fund discounts reached as high as 85%), discounts have narrowed, but have range traded around 20% for the last few years.

This means investors are faced with added volatility when compared to the underlying investments, and results in the need for diligent trading.

Annualised Return – According to Year of Investment



Listed Private Equity – Premium/Discount Over Last 10 Years



Sources: Preqin, Red Rocks Capital, Thomson Reuters EIKON, Bloomberg, KPMG Calculations.

Considerations of Listed Alternatives (cont.)



Liquidity

Listed Alternatives are often advertised as being extremely liquid. Our view however is that these vehicles are not as liquid as described because:

- These vehicles are still relatively niche compared to traditional shares, meaning the potential investor base is smaller;
- Shares are often tightly held by long term investors, reducing dealing volume;
- Information on underlying positions is difficult for investors to source, resulting in transparency issues and information lags.

Opportunities

Unlike with traditional alternatives investing, where investors can be specific on the exposures they desire by geography or strategy (e.g. choosing to invest in Europe only or in venture capital), investing through liquid vehicles provides the investor with less opportunity to dictate exposures, as portfolio exposure is solely at the manager's discretion.

We also believe managers are restricted in deal making by the need to focus on liquidity and reporting requirements – meaning the best deals may be forgone, or returns compromised.

As such, we believe it is difficult to access the best opportunities in private markets through listed vehicles.

Fees

Some listed vehicles attract an additional layer of fees such as the trust charges, administration fees and an additional management fee above the manager's normal fee scale. These fees are taken from the underlying investments and, make listed access a less attractive investment when compared to shares of other companies listed on the same index.

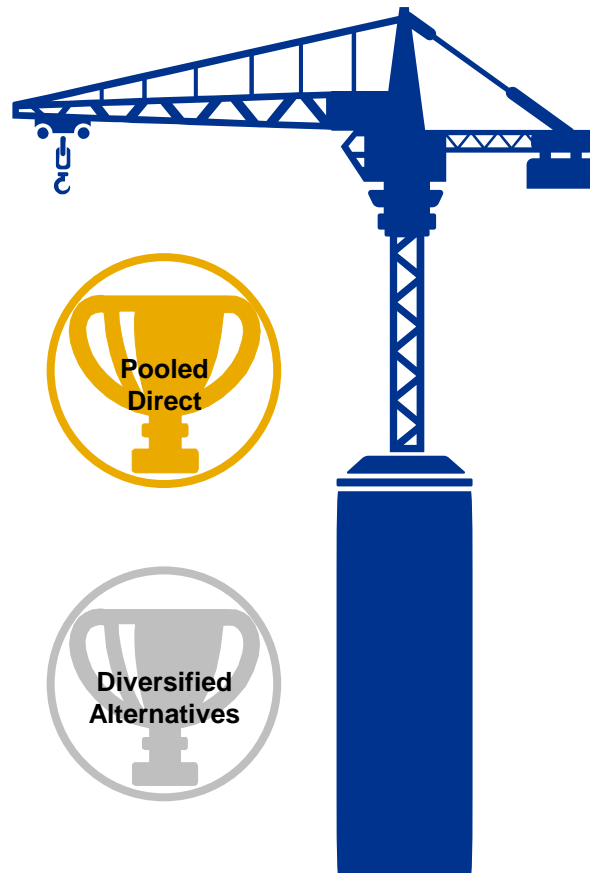
What is the best way to gain access to these opportunities?

Yes to Direct, No to Listed...

Our preferred method is pooled direct investment (e.g. a balanced or long lease property fund is favoured over an investment in REITS or a pooled large cap buyout fund over listed private equity). We believe if schemes can afford the additional governance requirements and illiquidity, they will be best served by pooled funds which make direct investments.

But what if direct investment is not possible? We do not believe listed private market assets are an effective way for pension schemes to access alternative investments.

For the reasons discussed on the previous pages, we do not believe that these access routes provide investors with the true characteristics of the asset classes they are trying to gain exposure to.



Is there another way to overcome the barriers of direct investment without the weaknesses of listed alternatives?

Yes, we think so!

Our view is that **diversified alternatives funds** are an attractive way for pension schemes to access alternatives. These funds are single pooled vehicles that invest in a mix of private market strategies such as Private Equity, Private Debt, Private Real Estate and Infrastructure.

Whilst return expectations are slightly lower than equivalent direct investments, we believe the advantages of this access route are:

- **Greater Liquidity** – small allocations to liquid strategies (e.g. commodities) means monthly or quarterly liquidity can be offered (with some gating provisions) which we believe is the optimum level of liquidity. Maintaining assets to provide daily liquidity would be too onerous and long lockups (e.g. quarterly or annual) are likely to be too illiquid for some schemes.
- **Flexibility** – the manager can tactically allocate to the best opportunities over time without worrying about quarterly reporting requirements.
- **Reduced Vintage Effect** – these funds offer immediate access to an established portfolio of investments diluting the impact of investing at a particular point in time.
- **Reduced Governance** – the fund manager manages the drawdowns and distributions within the fund.
- **Accessibility** – variants of these types of funds are available as pooled funds and through platform solutions (for both DB and DC investors).



The contacts at KPMG in connection with this report are:

Asad Rashid

Head of Alternatives Research

Tel:0207 311 2176

asad.rashid@kpmg.co.uk

Luc Pascal

Consultant

Tel:0118 964 2561

luc.pascal@kpmg.co.uk

Jonathan Craddock

Assistant Consultant

Tel:0207 311 8526

jonathan.craddock@kpmg.co.uk



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