

Investing in private market alternatives

Part I - Market Growth, Opportunities and Risks

February 2023

By **Michael Sager & David Wong**

Approximate reading time: 15 minutes



Summary

- Private markets have grown vigorously in the past decade, and so has the opportunity for a broader set of investors to participate in private market alternative investment solutions.
- Alternatives offer investors significant opportunity, including the ability to access diversifying sources of expected return and income not available via traditional long-only public market solutions. We believe that portfolios can be enhanced by a thoughtful allocation to a broad set of private market solutions.
- Private market investments are very different to traditional public solutions, and are not appropriate for all investors. Even for qualified investors, private market investing requires selectivity. Rigorous manager research is crucial to enable investors to attain appropriate knowledge and confidence.

Introduction

This is the first in a four-part series of papers that aims to provide investors with a broad appreciation of private market alternative investment solutions. Private markets have grown strongly over the past decade. Investment opportunities in a range of eclectic alternative opportunities are increasingly accessible to individual and high net worth (HNW) investors. In this first paper, we discuss recent private market growth, as well as investment opportunities and risks. The second paper will explore the methods of manager research as a means of identifying and appraising the opportunities and risks inherent in private market investing, including ESG. The third paper in the series will provide a deep dive road map through the various characteristics of the main private market investment opportunities: private credit and equity; real estate; infrastructure; and hedge funds. The final paper will address the question of how much to allocate to private market alternatives within investor portfolios.

A broad mosaic

They include less liquid private asset classes such as private equity and credit. They also include structured products that pool assets such as bank loans to provide repackaged risks and capital structures, real assets such as private real estate and infrastructure, natural resources and farmland, and intangible collectibles such as patents and copyrights, music publishing royalties, and Non-Fungible Tokens.¹ Each one of these asset classes can in turn be sub-divided into an eclectic set of distinct investment opportunities, and risks.

Unlike traditional investment solutions, alternative strategies are not constrained to long-only, benchmark-relative positions. They provide investors with the ability to express the full range of investment insights by implementing both long and short positions across and within various public and private market asset classes, often with the use of leverage. Liquid alternative strategies implement long/short positions exclusively in public markets, using similar investment strategies to hedge funds. Liquid alternatives have a regulatory requirement to offer investors daily liquidity. By contrast, hedge funds impose limits on fund liquidity to facilitate implementation of positions in less liquid corners of the financial markets where inefficiencies and informational asymmetries may be relatively more persistent, and opportunities for skilled investors to realize diversifying outsized returns are commensurately higher.

Complements, not substitutes

Alternatives should be viewed as complements, not substitutes, to traditional asset classes. Investors are not presented with a choice between investing in traditional public assets or private alternatives, or between one private alternative versus another. Instead, their challenge is to determine how best to combine all of these opportunities into a more efficient portfolio than one that draws solely upon traditional long-only public market solutions.

Each private market alternative offers distinct attributes to investors (Chart 1). Private equity offers the potential for enhanced expected returns relative to public equity, as a reward for illiquidity and complexity. And within private equity, venture capital provides access to a different expected return opportunity than growth or buyout categories.

Chart 1 - Private market alternatives offer investors a range of distinct attributes

Private market alternative	Purpose for portfolio allocation				
	Enhanced return	Enhanced income	Enhanced diversification	Hedge against inflation	Hedge against tail risk
Private equity	✓		✓		
Private credit	✓	✓	✓	✓	✓
Real estate debt	✓	✓	✓	✓	
Real estate equity	✓	✓	✓	✓	
Infrastructure debt		✓	✓	✓	
Infrastructure equity	✓		✓	✓	
Hedge funds	✓		✓	✓	✓

The information was prepared by CIBC Asset Management Inc. This chart is for illustrative and general information purposes only.

Private credit also provides investors with an enhanced expected yield relative to public market comparables, such as bank loans or high-yield bonds, and, in the case of direct lending strategies, floating interest rates which provide an ability to better hedge against rising interest rate risk. Diversification is also potentially available given the eclectic mix of sectors and structures encompassed by this asset class.

Real estate and infrastructure offer the possibility of steady income streams in strategies that emphasize the quality of assets. In addition, there can also be a greater ability to hedge inflation risks—particularly in sectors where rent or toll resets occur on a frequent basis and the threat of substitution is low. These types of private assets can also hold the potential to augment expected returns in cases where investors are willing to take on more development risk.

Hedge fund strategies can provide diversification benefits that help smooth the profile of long-term expected returns. They also offer the opportunity to implement tail hedges that seek to mitigate the risk of loss during periods of market stress.

Myriad risks alongside opportunity

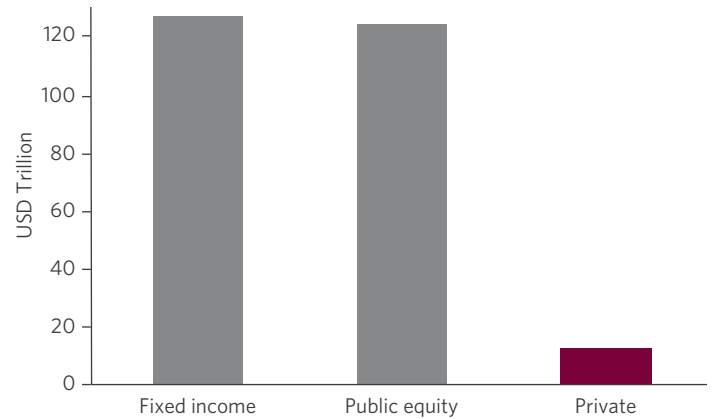
Private market alternatives are not a panacea. They are very different to public markets, and are not appropriate for all investors given the effort and risk tolerance needed to participate. They are heterogeneous, often complex, and are more opaque and less liquid than traditional public investments. They have less disclosure requirements and fewer regulatory constraints—such as leverage—and as a result have less protections. They often involve layers of embedded fees. For all these reasons, most private market investment solutions are available only via Offering Memorandum and not prospectus. This limits their availability to accredited investors, with strict hurdles around income level, assets, and other criteria. And even for this cohort, the use of private market solutions requires selectivity. Rigorous investment and operational due diligence is at a premium, along with an acceptance of higher risk.

In some quarters, there has been a headlong rush to recommend investors add alternatives to portfolios. The motivation for this urgency is not always apparent. Allocating to alternatives only makes sense if they enhance expected outcomes associated with an investor’s existing portfolio. Given the additional risks involved, any supplementary portfolio utility needs to be carefully measured.

Sketching the growth of private market alternatives

In terms of absolute size, the market capitalization of private market alternatives remains relatively small compared with public equity and fixed income markets (Chart 2).

Chart 2 – Private markets market capitalization remains small in comparison to traditional public markets

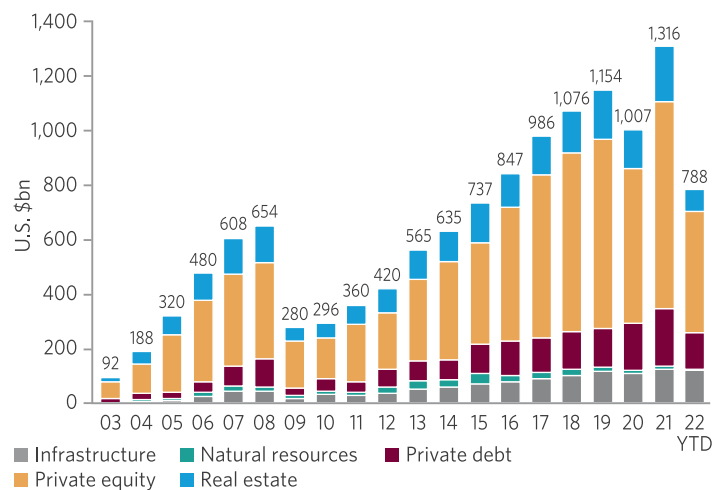


The information was prepared by CIBC Asset Management Inc. using the following third-party service providers’ data: McKinsey & Company (2020), Preqin, SIFMA Capital Markets Fact Book 2022, (<https://www.sifma.org/resources/research/fact-book/>). Data as at December, 2021 for public markets, & March 2022 for private markets. Data accessed as at September 22, 2022.

Vigorous growth

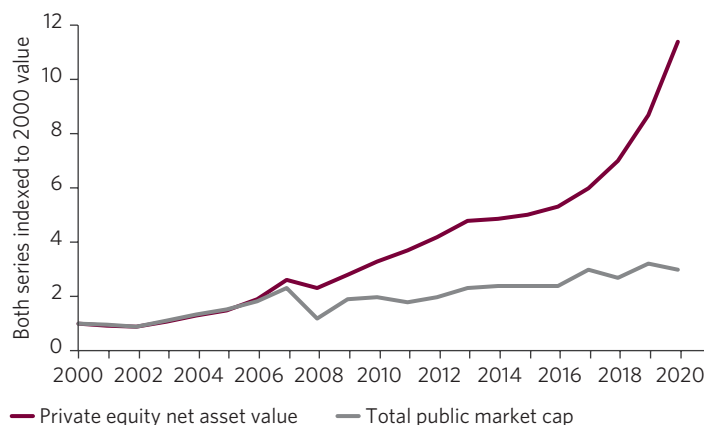
But the growth rate of private markets has been particularly impressive (Charts 3 and 4). Private equity continues to lead the way. The size of private equity funds is growing larger, the gap between fundraising rounds has declined, and the average fund is exceeding capital raising targets, by 18% in 2022.¹ Other asset classes have realized solid growth, too. As a result, private markets are becoming an increasingly important source of capital for the global economy, and an increasingly viable opportunity for investors.

Chart 3 – Private market fundraising reached record levels in 2021²



The information was prepared by CIBC Asset Management Inc. using the following third-party service providers’ data: Preqin. Data as at August 18, 2022. YTD = Year-to-date, defined as January - June 2022.

Chart 4 – Private equity net asset value and public market capitalization, both indexed to 2000 value



The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: McKinsey & Company (2022), Preqin. Net asset value = Assets Under Management minus dry powder, i.e. available capital that has not yet been utilized. Public market capitalization ("Cap") is based on the total market capitalization of companies globally. Data as at December 2020.

And the beat goes on

The scope for continued vigorous growth in private market alternatives appears substantial. Private companies constitute more than 99% of all U.S. employer firms, and 86% of U.S. firms with 500 or more employees. In Canada, of 1.22 million employer companies, just 2,200 are publicly listed.^{3,4} Anecdotally, Pitchbook—a well-known source of private market data and analysis—provides research coverage on 3.4 million private firms, and just 102,000 publicly listed companies.⁵ Evidence suggests the trend growth rate of private companies remains vigorous and that many firms are choosing to remain private for longer, fueling greater demand for private market financing solutions to fund future growth.⁶

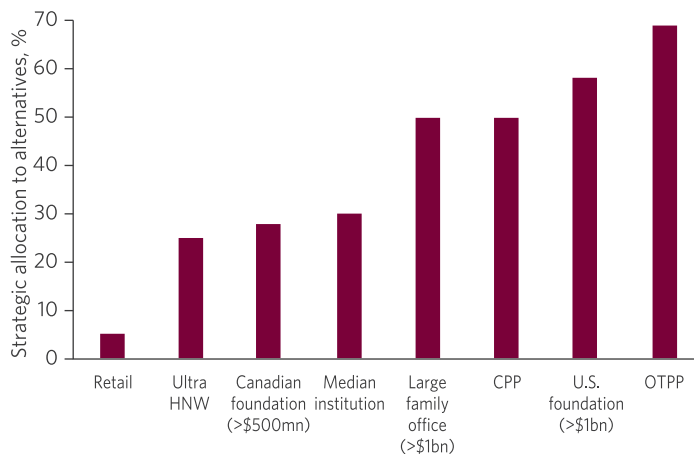
For real assets, the gap between projected and required global infrastructure spending through 2040 is projected at \$15 trillion, including on megatrends such as the transition to green infrastructure, urbanization, and digitization.⁷ Private infrastructure funds raised \$117 billion in 2021, so there is plenty of scope for this sector to grow and satisfy a substantial chunk of megatrend capital funding requirements.⁸ And many countries are confronted by a shortage of real estate, particularly in terms of various housing sectors. Again, this provides an important opportunity for private capital and, by extension, private market investors.

So the canvas of investment opportunities available to private market investment managers and investors will likely remain very extensive for the foreseeable future.

Lessons from institutional asset allocation trends

Private market alternatives have long been a key component of institutional, family office, and endowment portfolios (Chart 5). Even so, survey data suggest allocations have yet to reach steady-state (Nuveen, 2022; Jupe, 2022, op. cit.).⁹ And the mix of alternatives in institutional portfolios underscores the complementarity of the various opportunities (Chart 6).

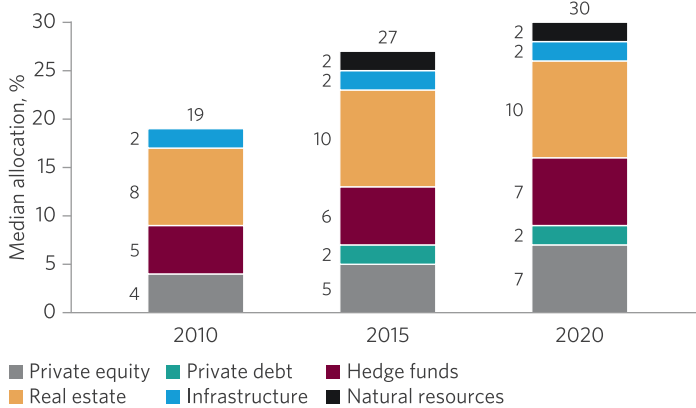
Chart 5 – Strategic allocations to alternatives differ across investor type



The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Ninepoint, Blackstone, Global Pension Study 2018, Willis Towers Watson, Ontario Teachers' Pension Plan (OTPP), Canada Pension Plan (CPP), RBC, KKR, Preqin, Mercer Investment Survey, April 2021; BNY Mellon Endowment & Foundation Performance and Asset Allocation Study & Endowment 2020. Median Institutional based on data from Future of Alternatives 2025: Investors' Inexorable Push to Alternatives. Melissa Lee. Preqin (2020). Data as at April 2021.

Ultra-high net worth (UHNW) investors have also already embraced the opportunity presented by private markets. By contrast, retail investors are at an early stage of participation. This includes both the size of allocations within overall portfolios, as well as the sophistication of available solutions. For instance, many retail investors active in real estate and infrastructure participate via REITS or listed funds that provide access via publicly listed securities. The participation of this cohort is expected to grow and evolve over time. We return to this topic in the third installment of this series of papers.

Chart 6 – The median Canadian pension plan allocates around 30% of AUM to an eclectic mix of alternatives

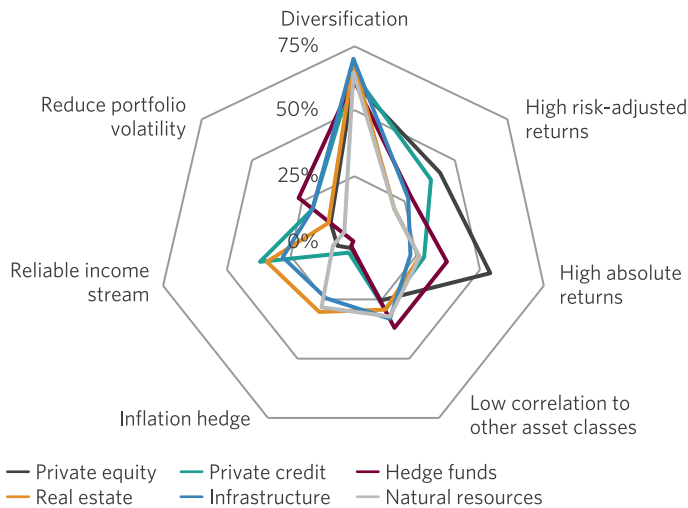


The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Ninepoint, Blackstone, Global Pension Study 2018, Willis Towers Watson. Data as at December 2020. AUM = Assets Under Management.

Investing in private market alternatives—the opportunity

Several features motivate investor interest in private market alternatives. These include enhanced expected return and income, enhanced diversification, and volatility and tail risk hedging (Chart 7).

Chart 7 – Investors identify a range of criteria for investing in alternatives

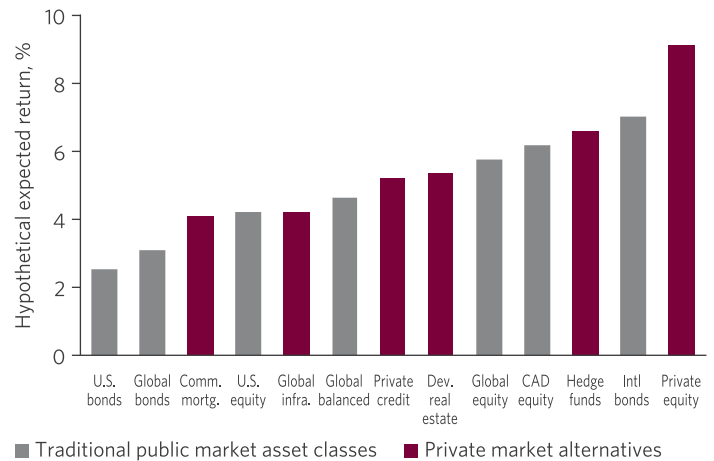


The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Preqin (2020). Percentages indicate the percentage of survey respondents who identified each criterion as an important motivation for investing in alternatives.

Enhanced expected return

At the core of the investment case for private market alternatives is the opportunity to enhance expected returns (Chart 8).¹⁰ This opportunity arises from a willingness to forego liquidity and to participate in niche, emerging or segmented markets and sectors. Here, information asymmetries, frictions and heterogeneities are relatively persistent, complexity and transaction and search costs are high, and competition is scarcer (Chart 9). All these facets enable investors with skill, and often scale, to prosper.

Chart 8 – Long-term hypothetical expected returns remain relatively attractive for private market opportunities



The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Bloomberg LLC.; Refinitiv Datastream. Data as at May 31, 2022. Global Balanced defined as: 60% MSCI AC World Index; 40% Global Fixed Income (JP Morgan Ex. CAD). Mortg. = Mortgages; Infra = Infrastructure; Dev = Developed; CAD = Canadian; & Intl = International. This hypothetical scenario is shown for illustrative purposes only and is not indicative of future results. Please refer to the Disclaimer page for further information. Methodology for calculation of hypothetical returns available at https://www.cibcassetmanagement.com/email/assets/documents/pdfs/JB88_RB_042120_CAM_10YearForecast_En_Final.pdf.

The 2022 equity market and 2020-2022 fixed-income market corrections have rendered this motivation a little less urgent, as long-term hypothetical expected returns to traditional public market solutions have improved. But it remains a truism that investors prefer more expected return to less, for a given level of risk. Allocating to private markets may provide this enhancement.

Chart 9 – The illiquidity premium

What is the illiquidity premium?	
<ul style="list-style-type: none"> An expected return premium to compensate for accepting exposure to intrinsic illiquidity within an asset class. Liquidity provides investors with options; illiquidity constrains them. An illiquid asset cannot easily be sold to meet unexpected spending needs or to take advantage of better investment opportunities. A willingness to accept this constraint should be rewarded. Illiquidity premium can reflect: participation and transaction costs; search frictions; asymmetric and imperfect information. 	
Where can we harvest an illiquidity premium?	
<ul style="list-style-type: none"> Off-the-run fixed-income securities (“on-the-run/off-the-run bond spread”). Less liquid corporate bonds, versus more liquid issues. 	<ul style="list-style-type: none"> Private equity. Real assets, including real estate, infrastructure, and farmland.
Where should we not expect an illiquidity premium?	
<ul style="list-style-type: none"> For acceptance of exposure to artificial gates and lock-ups not intrinsic to the underlying risk exposure. Manager dispersion, partially caused by vintage year of funds, is much greater in private markets than in liquid public markets. An ability to select top-performing managers, in addition to harvesting an illiquidity premium, will be a key determinant of realized returns to private assets and strategies. 	

The information was prepared by CIBC Asset Management Inc.. This chart is for illustrative and general information purposes only.

Diversification

Private market alternatives can provide diversification through two routes. First, by allowing investors access to opportunities, and risks, not available from traditional public market vehicles. For instance, private commercial mortgages and private infrastructure debt provide different sources of risk and return relative to an investment in developed market

sovereign or corporate bonds (Chart 10). Similarly, an allocation to a merger arbitrage hedge fund strategy will provide exposure to a different set of risks than a long-only large cap equity fund. Combining complementary risks in a portfolio provides greater breadth and diversification, and enhances expected performance.

Chart 10 – Attractive correlations suggest investors can improve portfolio diversification by allocating capital to a broad set of private market alternative solutions

Asset class	CAD equity	S/T bonds	Core bonds	Corporate bonds	HY bonds	Global bonds	EM bonds	Comm. mortgages	Private credit	Global infra.	Private real estate	Private equity	Hedge funds
Canadian equity	1.00												
S/T bonds	-0.21	1.00											
Core bonds	0.14	0.08	1.00										
Corporate bonds	0.31	-0.07	0.90	1.00									
High yield bonds	0.69	-0.47	0.25	0.55	1.00								
Global bonds	0.16	0.12	0.56	0.52	0.31	1.00							
EM bonds	0.51	-0.06	0.40	0.53	0.55	0.53	1.00						
Commercial mortgages	0.05	0.07	0.69	0.64	0.54	0.49	0.36	1.00					
Private credit	0.23	0.08	0.93	0.84	0.37	0.72	0.47	0.58	1.00				
Global infrastructure	0.75	-0.14	0.23	0.34	0.54	0.48	0.66	0.13	0.26	1.00			
Real estate	0.66	-0.17	0.20	0.36	0.60	0.41	0.61	0.19	0.32	0.83	1.00		
Private equity	0.09	-0.06	0.01	0.02	0.02	0.01	-0.03	0.04	0.03	0.11	0.08	1.00	
Hedge funds	0.42	0.06	0.23	0.09	0.07	0.25	0.21	0.08	-0.16	0.37	0.33	0.07	1.00

Blue Cells Indicate highest potential diversification. Numbers below 0.30 indicate opportunities for the greatest diversification benefit. Numbers above 0.31 indicate smaller diversification benefit, while 1.00 represents no diversification benefit.

The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Bloomberg Finance L.P.. Maximum sample is January 1973 to June 2022. All data expressed in Canadian Dollars. Core Bonds: CIBC Canadian Core Bonds Pool; Short-Term Bonds: FTSE Canada 91 Day T-Bills Index; Corporate Bonds: FTSE Canada All Corporate Universe Bond Index; High Yield Bonds: FTSE Canada High Yield Overall Bond Index; Commercial Mortgages: ACM Commercial Mortgage Fund; Private Credit: CIBC Long-Term Private Debt Pool; Global Bonds: Bloomberg Global-Aggregate Index; Emerging Market Bonds: JPMorgan EMBI Plus; Global Infrastructure: Dow Jones Brookfield Global Infrastructure Index, Real Estate: S&P Developed Property Index; Private Equity: Kensington Private Equity Fund, Hedge Funds: HFR Macro Index, Canadian Equities: S&P/TSX Index. Correlation matrix equally weighted.

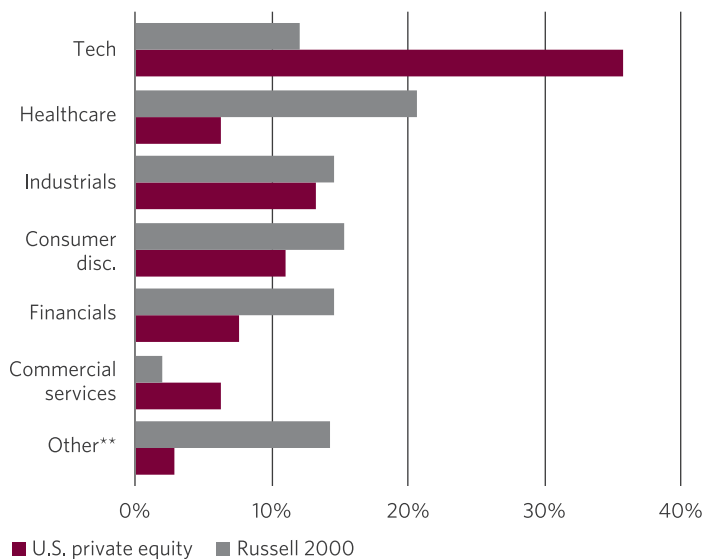
Traditional balanced portfolios often exhibit concentrated exposures to growth and inflation risks, performing well when economic growth is robust, and less well in periods when the economy is relatively moribund. Adding an eclectic mix of alternatives, including private market solutions, can help smooth out this performance profile, making portfolios more resilient to the economic cycle, and concurrently enhancing expected return.

The second source of diversification comes from artificial return smoothing associated with private market alternatives. This smoothing reflects irregular marking-to-market of fund net asset values (NAV), due to the illiquidity of underlying investments. It allows valuation methodologies to look through market volatility and concentrate upon the long-term fundamentals driving expected future cash flows. The voting machine of the public markets is replaced by the weighing machine of a private valuation process.

Return smoothing is valued by many investors. It eliminates excessive volatility observed in the public equity markets over short to intermediate investment horizons. It reduces pension plan funding and contribution rate volatility, and minimizes the extent of reported losses during equity market stress for all investors. It also minimizes the risk of ill-timed asset allocation switches during periods of market downturn. These switches often lead to long-term underperformance relative to a portfolio that remains fully invested (the so-called investor gap).

Return smoothing comes at a price. This includes a reduction in the magnitude of any expected return premium from allocating to alternatives; investors have to pay for the ability to look through market volatility. Smoothing may also obscure the true risk of an investment, which presents measurement challenges and has the potential to breed investor complacency. To emphasize this point, the technology sector has been particularly adversely impacted at times during the 2022 public market equity correction. This sector often has a high weight within private equity funds (Chart 11). While the valuation sentiment of the public market may ultimately prove to be too short-term focused, private equity might not be immune to the market correction, if the speculation of perceived fundamental challenges becomes a reality in underlying businesses. This applies to other private market alternatives, too. It is difficult to consistently make wine from water.

Chart 11 - Information technology often has a high allocation in U.S. private equity funds



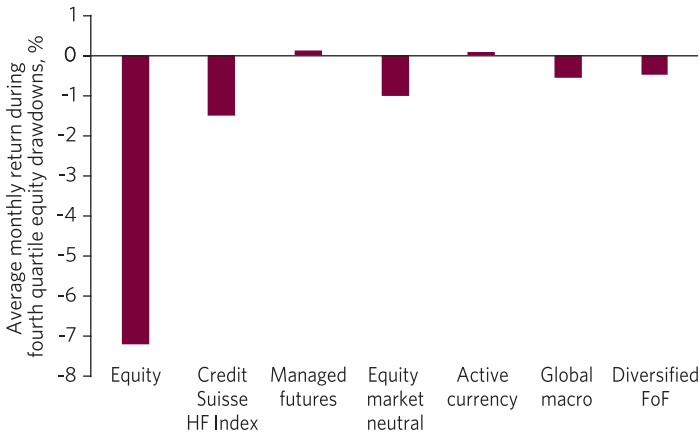
The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: JP Morgan Asset Management, Cambridge Associates, Russell. Percentages may not sum to 100% due to rounding. **Other includes real estate, utilities, and energy. Sector weights as of June 31, 2021. Data is based on availability as of May 31, 2022.

Volatility management and tail hedging

Private market alternatives are expected to help smooth the profile of portfolio returns. This smoothing results partly from valuation methodologies, as discussed above. It also comes from accessing strategies more adept at mitigating the impact of specific risks. These risks include periods of heightened inflation and inflation uncertainty, as well as recession and equity drawdown risk. For instance, floating rates offered by some segments of private credit, inflation-indexed rental income in real estate, and contractual agreements offered by many infrastructure assets mean that all these asset classes represent attractive fundamental hedges against inflation.

Risk mitigation through a combination of diversification and tail risk hedging is often considered the primary purpose of an allocation to hedge funds (Chart 12). There are many hedge fund strategies to select from. Some are relatively narrow and exploit a specific risk; for instance, short-bias funds designed to profit during periods of equity market drawdowns. Others are broad and expect to deliver relatively consistent returns that exhibit low correlation to both public equity and fixed income. Examples include macro, multi-strategy, and hedge fund of funds. And managed futures implement processes designed to exploit trends and have often been effective at hedging tail risk during periods of equity and fixed income market drawdowns.

Chart 12 - Hedge fund strategies have demonstrated an ability to mitigate tail risk



The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: CAIA, Bloomberg LLC.. Maximum sample: January 1994 to July 2022. "HF" = Hedge Fund. "FoF" = Fund of Funds.

Investing in private market alternatives—the risks

Not all alternatives diversify risks inherent in public market exposure

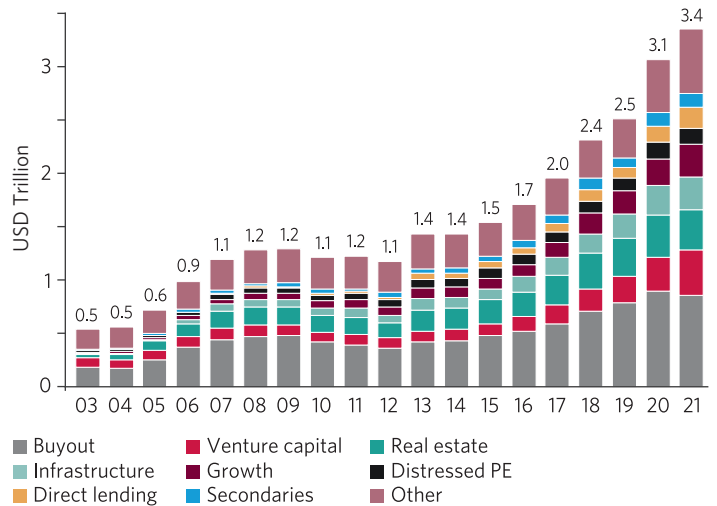
Some private market alternatives load on risk factors similar to traditional public market solutions. For instance, within private equity, venture capital exhibits evidence of a positive exposure to the size risk factor similar to small cap public equity. Buyout strategies often exhibit a positive loading on value.¹¹ These risk exposures mean there is often substantial overlap between traditional public solutions and private market alternatives in terms of the sources of value-added that both offer to investors.¹²

The magnitude of expected value added may well be persistently higher in private markets than public market equivalents, at least for top quartile managers, but investors have to ensure they understand the source of the risk, and the reason why it merits inclusion in their portfolio. Only those asset classes and strategies that have fundamentally distinct sources of value creation, and therefore risks, offer true diversification.

Valuations

Given a variety of factors including accommodative monetary policy, many private market alternatives have relatively high valuations, similar to traditional public assets. This means that future return expectations are lower than the historical performance investors have become accustomed to, including from top-quartile private managers. As Treon (2022) highlights, strong market growth and fundraising are a double-edged sword: with dry powder reaching a record high in 2021 (Chart 13), managers across private markets are under pressure to allocate this capital at valuations that may be excessive. This makes future returns more challenging.

Chart 13 - Record dry powder may pressure private funds to do deals



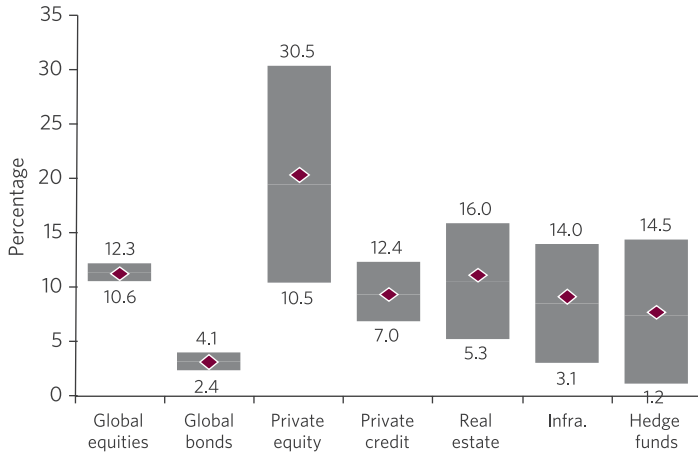
The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Preqin, Bain & Company, "The Private Equity Market in 2021: The Allure of Growth". Data as at December 2021. PE = Private Equity.

It is also important to understand how private alternative managers calculate fund valuations, given that many holdings are illiquid. One of the key priorities in manager research is to ascertain whether valuation processes are sensible and consistently applied, and subject to third-party validation.

Performance dispersion and persistence

The range of historical performance outcomes is wider for private market alternatives than for traditional public market investments (Chart 14). The persistence of manager performance is also often lower (Chart 15). Both facets again place a premium on rigorous manager research and selection.

Chart 14 - Historical performance dispersion is higher in private market alternatives than in public markets



The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: McKinsey & Company (2022), JP Morgan Asset Management, Lipper, NCREIF, Burgiss, HFRI, PivotalPath. The top & bottom of each bar indicate the top & bottom quartiles of manager performance. The red diamonds indicate median manager performance. Calculated using returns from March 2012 to March 2022. Global equities (large cap) & Global Bonds dispersion are based on the world large equity & world bond categories, respectively. Data are based on availability as of May 31, 2022. Infra = Infrastructure.

Chart 15 - Private market manager performance persistence is relatively low

Private equity (buyout) fund persistence by quartile performance

Fund quartile (previous quarter)	Fund quartile (current quarter)			
	1st	2nd	3rd	4th
1st	29.2	24.6	30.8	15.4
2nd	19.4	28.4	29.9	22.4
3rd	21.0	25.8	29.0	24.2
4th	24.3	13.5	16.2	46.0

Intensity of colour highlights intention to draw attention to cells of more or less performance persistence. Quartiles with a range below 21 indicate the lowest persistence, while ranges between 22-26 indicate neutral persistence. Ranges above 27 indicate highest level of persistence for the fund quartile.

The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Cambridge Associates; OSAM; FactSet; BlackRock (2020), Private Markets 2020. Sample: 2000 - September 2019. Data as at June 30, 2020.

Illiquidity and leverage

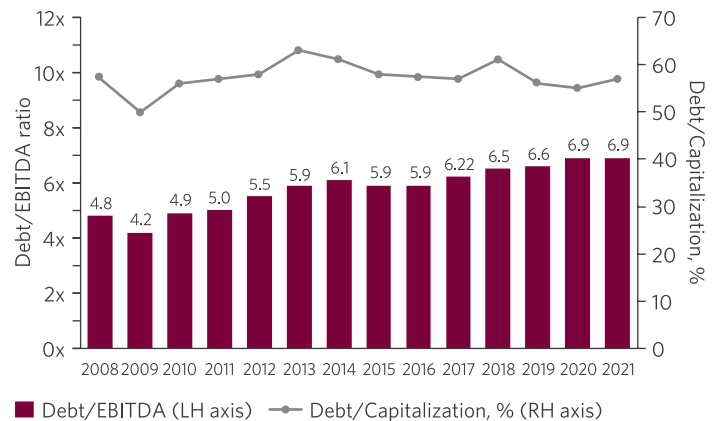
Many investors are willing to accept exposure to illiquidity risk since it is associated with a positive premium. Illiquid assets typically trade at a discount to compensate investors who forego the convenience of liquidity. For other investors, liquidity continues to be a concern, and this cohort is looking for better tools to understand, evaluate, and mitigate this risk.¹³ Whatever an individual investor's attitude towards illiquidity, it is important to size this risk appropriately, to complement other features of investor portfolios. Replacing one concentrated risk with another is typically not an optimal strategy.

Most alternatives utilize at least some leverage. Liquid alternatives are limited by regulation in Canada to using leverage equivalent to no more than three times their fund's NAV. In addition, this leverage is often created by the use of derivatives to implement positions. For instance, forward currency contracts require only a fractional initial margin payment.

This level of leverage is relatively benign compared with balance sheet leverage used in private market alternatives. Here, funds often borrow to invest and boost expected returns. The amount of leverage inherent in private alternatives can be relatively high (Chart 16), occasionally reaching levels perhaps indicative of excessive risk-taking. In an environment of rising interest rates, leverage itself becomes more risky. Along with non-traditional product structures and fee opacity, the use of leverage will be an important limiting factor for some investors on the extent of their participation in private market alternatives.

Chart 16 - The use of leverage in private market alternatives is common and often substantial

U.S. private equity buyout leverage metrics



The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Refinitive Datastream, McKinsey & Company (2022), Private Markets Rally to New Heights, in McKinsey Global Private Markets Review. Data as at December 2021.

Artificial return smoothing and risk measurement

It is important to be clear as to what we mean by risk in private markets. As discussed above, in many cases returns to private market alternatives are artificially smoothed, reflecting irregular marking-to-market of fund NAVs. This smoothing alters the profile and volatility of returns—and therefore their fit within a portfolio—and can encourage a false sense of security during periods of generalized market drawdowns. It requires investors to broaden their definition of risk beyond a common reliance upon standard deviation, and pay attention to risk metrics such as value at risk, leverage, cashflow, and liquidity to adequately assess the risks in their portfolio.

Manager specific investment, operational, and organizational risks

Given the reliance on specialized managers to access alternative return streams, manager-specific risks are a key source of risk in the private markets. We dedicate the second installment in this series of papers to a discussion of issues related to this topic, including the CIBC Asset Management manager research framework.

Conclusion: Take a team approach to private alternative investing

In this paper, we have attempted to provide a balanced view of the unique benefits and risks of private market alternative investing. Ultimately, we consider the potential benefits to be very attractive. Many of the risks can be mitigated with a professionally managed support system around asset allocation, as well as by diversifying types of alternatives, and by utilizing manager research to help investors govern the controllable elements of private market investing.

Equally important is ongoing access to experts who can provide context and updates to respond to ever-changing market dynamics. Sophisticated institutional investors have been able to meaningfully enhance portfolio performance with this approach. With over 50 years of history and resources designed to bring this ecosystem to intermediaries, CIBC Asset Management is a great alternative for alternatives.

To learn more about private market alternative investment solutions, please contact your advisor at CIBC Private Wealth.

About the authors



Michael Sager, Ph.D.
Managing Director & Chief
Investment Officer,
Multi-Asset & Currency
CIBC Asset Management



David Wong, CFA, FRM
Chief Investment Officer,
Managing Director & Head,
Total Investment Solutions
CIBC Asset Management



About CIBC Asset Management

At CIBC Asset Management, we believe that every customized investment solution begins with research and rigour. We specialize in a variety of investment solutions such as equities, fixed income, currency management, liability-driven investments, asset allocation, and responsible investments.

Across a spectrum of investment solutions, we commit to robust research. Dedicated sector and regional analysts focus on industry research and security-specific idea generation. Our investment professionals leverage deep and diverse expertise by sharing proprietary research across asset-class teams. By sharing insight across asset class teams, we maximize opportunities to add value to our client portfolios.

Contact us any time

To learn more about [CIBC Asset Management](#) and our investment solutions, please contact your advisor.

For more insights, connect with us on [LinkedIn](#).

¹ Preqin, as reported by Jupe, A. (2022), Fundraising Frenzy: Navigating Private Market Manager Selection. Goldman Sachs Asset Management Perspectives, Summer 2022. <https://www.gsam.com/content/gsam/us/en/institutions/market-insights/gsam-insights/2022/fundraising-frenzy-navigating-private-market-manager-selection.html>.

² 2022 H1 fundraising reached \$639bn. Source: Pitchbook (2022) Global Private Markets Fundraising Report. Data accessed as at 18 August 2022.

³ <https://www.nber.org/papers/w12354>

⁴ For the U.S.: <https://www.forbes.com/sites/sageworks/2013/05/26/4-things-you-dont-know-about-private-companies/?sh=60a71eb4291a>. For Canada: <https://www.ic.gc.ca>

⁵ <https://pitchbook.com/platform-data/companies>. Data accessed as at August 16, 2022.

⁶ BlackRock (2022), Private Markets Outlook, and Ritter (2021), as reported by Murphy, D., J. Hadas, & M. Hillman (2022), & Wanted: Sources of Return in Private Alternatives. Goldman Sachs Asset Management (op. cit.). Measured based on average age of company at IPO.

⁷ Oxford Economics (2017), Global Infrastructure Outlook to 2040. <https://blog.oxfordeconomics.com>

⁸ Preqin.

⁹ Nuveen (2022), Think Equilibrium Climate of change: 2022 Global institutional investor study.

¹⁰ Our data only include asset class and strategy hypothetical beta expected returns. We exclude any assessment of potential alpha. This may be an additional source of return, depending upon the performance of individual fulfilments selected by an investor.

¹¹ Vanguard (2020), The Role of Private Equity in Strategic Portfolios; and L'Her, J.-F., R. Stoyanova, K. Shaw, W. Scott, & C. Lai (2016), 'A Bottom-Up Approach to the Risk-Adjusted Performance of the Buyout Fund Market. Financial Analyst Journal, Vol. 72, No. 4, pp.36-48.

¹² As Murphy, Hadas, & Hillman (2022) op. cit. argue, within this overlap Private Equity firms do have a larger opportunity set to choose from, given the relative number of private companies, and tend to be active amongst the earliest, most innovative, highest-growth opportunities.

¹³ SEI Investment Manager Services (2022), Back to the Future.

The views expressed in this material are the views of CIBC Asset Management Inc. as of February 2023 unless otherwise indicated, and are subject to change at any time. CIBC Asset Management Inc. does not undertake any obligation or responsibility to update such opinions.

This material is provided for general informational purposes only and does not constitute financial, investment, tax, legal or accounting advice, it should not be relied upon in that regard or be considered predictive of any future market performance, nor does it constitute an offer or solicitation to buy or sell any securities referred to.

Individual circumstances and current events are critical to sound investment planning; anyone wishing to act on this material should consult with their advisor. The material and/or its contents may not be reproduced without the express written consent of CIBC Asset Management Inc. Past performance may not be repeated and is not indicative of future results.

Forward-looking statements include statements that are predictive in nature, that depend upon or refer to future events or conditions, or that include words such as “expects”, “anticipates”, “intends”, “plans”, “believes”, “estimates”, or other similar wording. In addition, any statements that may be made concerning future performance, strategies, or prospects and possible future actions taken by the fund, are also forward-looking statements. Forward-looking statements are not guarantees of future performance. These statements involve known and unknown risks, uncertainties, and other factors that may cause the actual results and achievements of the fund to differ materially from those expressed or implied by such statements. Such factors include, but are not limited to: general economic, market, and business conditions; fluctuations in securities prices, interest rates, and foreign currency exchange rates; changes in government regulations; and catastrophic events.

The above list of important factors that may affect future results is not exhaustive. Before making any investment decisions, we encourage you to consider these and other factors carefully. CIBC Asset Management Inc. does not undertake, and specifically disclaims, any obligation to update or revise any forward-looking statements, whether as a result of new information, future developments, or otherwise prior to the release of the next management report of fund performance.

“Bloomberg®” is a service mark of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited (“BISL”), the administrator of the indices (collectively, “Bloomberg”) and have been licensed for use for certain purposes by CIBC Asset Management Inc. Bloomberg is not affiliated with CIBC Asset Management Inc., and Bloomberg does not approve, endorse, review, or recommend any CIBC Asset Management Inc. products.

Hypothetical performance results have many inherent limitations, some of which are described below. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. In fact, there are frequently sharp differences between hypothetical performance results and the actual results subsequently achieved by any particular trading program.

One of the limitations of hypothetical performance results is that they are generally prepared with the benefit of hindsight. In addition, hypothetical trading does not involve financial risk, and no hypothetical trading record can completely account for the impact of financial risk in actual trading. For example, the ability to withstand losses or adhere to a particular trading program in spite of trading losses are material points which can also adversely affect actual trading results. There are numerous other factors related to the markets in general or to the implementation of any specific trading program which cannot be fully accounted for in the preparation of hypothetical performance results and all of which can adversely affect actual trading results.

Hedging: the offset or reduction of the risk associated with all or a portion of an existing investment or group of investments. Cross-hedging is permitted as long as there is a high degree of correlation between changes in the market value of the investment or group of investments to be hedged and the hedging instrument.

Creating effective exposures to certain markets: replication of equity, fixed income, money market, currency or other indices or securities, in order to reduce transaction costs and achieve greater liquidity. Facilitating the investment management process: increase the speed, flexibility and efficiency in the investment management operation of the client account. Enhancing returns: benefiting from a lower cost or locking-in of arbitrage profits, except for private client accounts.

® The CIBC logo and “CIBC Asset Management” are registered trademarks of CIBC, used under license.