Five Questions for Considering Private Markets

With attractive potential returns, prospective private market investors often ask: “How do I know if private equity is right for me? And where do I start?” While private markets have traditionally served institutional and ultra-high-net-worth investors (UHNW), high-net-worth (HNW) investors are now also able to access this alternative asset class. In fact, many HNW investors choose alternatives because they may benefit from outsized returns or a more diversified portfolio over a longer period of time. But with greater access comes more responsibility. So, it’s important to ask the right questions to get informative answers. Here are some to get you started:

1. What Is Your Investment Time Horizon?
2. Are You Comfortable with Less Liquid Assets?
3. How Could Private Investments Best Fit into Your Portfolio?
4. What Is Your Comfort Level with Private Markets’ Lower Levels of Investment Information?
5. Have You Considered Private Market Expenses?

WHAT YOU SHOULD KNOW:

- Most private market investments are illiquid and take time to mature, so investors should be mindful of how long they may need to be in the market before realizing any potential returns.
- Including private market investments in your portfolio has the potential to expand your interaction with the broader economy, which may increase diversification.
- Consider the fees associated with private market investments. These may include management fees, performance fees and other costs. Make sure you understand the fee structure and how it may impact your returns.

1 What Is Your Investment Time Horizon?

Every investor needs to ask themselves, “How soon do I need this money?” Other questions you may want to answer include whether open-ended or closed-end funds are right for you. Some investors prefer the flexibility that public markets afford them. For instance, the time horizon for publicly traded stocks could be as short as a single day or as long as several decades. Private markets, however, require a longer-term commitment. Unless investors are allocating capital to open-ended (evergreen) or semi-liquid funds, it often takes considerable time – years, not months – for private investments to realize their value. As such, investors should approach private markets with a long-term time horizon in mind.

Also, make sure you stay abreast of the new investment options in the market. Evergreen funds, for instance, are open-ended and allow institutional and HNW investors to become limited partners (LP) – institutional entities or individual investors that provide capital to a private equity fund – in a pre-existing fund at fair value. The evergreen structure has changed the way investors access private market investment opportunities and has opened the door for a broader investor base. These funds differ from traditional closed-end funds and duration is just one aspect of that (more on evergreen funds here).

2 Are You Comfortable with Less Liquid Assets?

Not only do private market investments often take longer to generate potential returns, as an asset class, private market investments are also less liquid. This is due, in part, to the lack of public exchanges where private market assets can be bought and sold.

Further, private markets are less liquid because of deal life cycles. To put this into context, a private equity fund’s returns are typically negative at first. This happens because this period, also known as the capital call period, is when the fund begins investing in various companies (i.e., portfolio companies). During this early phase, the fund incurs acquisition expenses. The portfolio companies may require additional investments to support growth initiatives, which may also affect returns.

This period of negative performance generally spans three to four years following the fund’s inception due to the fund’s management fees and expenses – though it eventually flattens out and becomes positive. This is referred to as a J-curve (more on J-curves here). Private market funds typically have 10-year terms and a classic J-curve profile, which is an important consideration for those investors who need greater liquidity..

3 How Could Private Investments Best Fit into Your Portfolio?

Private markets can play a few different roles in an investor’s portfolio. One of the primary goals is to deliver returns that exceed the public market, which has historically been the case. In fact, our data suggest that private markets have consistently outperformed global public equity and credit markets, respectively, in 21 of the last 22 years – even after all management fees, expenses and performance fees are accounted for.[1]

Private markets can also give investors exposure to the broader economy, thereby increasing portfolio diversification. For example, as of February 2023, there were 140,000 private companies with more than $100 million in annual revenue versus 19,000 public companies with the same revenues.2 The upshot? There are simply more opportunities to access a wider range of high-value investments in private markets than in public markets. And with many companies in excess of $100 million with annual revenues choosing to stay private for longer, investors may find that constructing portfolios with private market investments can provide greater return potential. If these attributes are desirable, investors should consider an allocation towards private markets.

[Read more here about the growth in private market investment opportunities.]

4 What Is Your Comfort Level with Private Markets' Level of Investment Information?

In public markets, we're all accustomed to market updates at the end of each trading day. Compared to public markets, private markets have a much different level of investment information. In private markets, net asset values (NAVs) are typically updated quarterly, so investors should be comfortable with seeing fewer valuation milestones. And it's key that you find a general partner (GP) – the manager of a private markets fund – who provides as much investment information as possible, particularly through valuations. For example, how often are assets valued and by whom? Are the assets valued internally or by an independent third party?

5 Have You Considered Private Market Expenses?

"Sure, private markets perform well, but what about the fees?" is a question we're regularly asked—and for good reason. Fees need to be accounted for when deciding whether or not private markets are right for you or your clients. Below are just some of the fees you should understand:

- **Management Fees:** The fund managers charge a management fee, which often varies over the course of the fund's life cycle. Think of it as compensation that the managers of a private equity fund receive for overseeing the fund. This annual charge is equal to a certain percentage of investors' initial commitments to the fund, most often ranging between 1% to 2.5%.
- **Carried Interest (or Performance Fees):** An additional fee component is carried interest, sometimes referred to as a performance fee or 'carry.' Carried interest is the percentage of investment profits—typically up to 20% for private equity funds—that LPs pay to the fund manager.
- **Hurdle Rates (Preferred Return):** In order for GPs to begin receiving carried interest, most private market funds must first realize a minimum annual return, or hurdle rate. Think of a hurdle rate as the minimum return that LPs are entitled to before paying carried interest to the GP. The typical hurdle rate in private equity is 8% and ranges between 6% to 7% for private credit funds.
- **Net Invested Capital Fees:** As the fund finishes its investment period, the management fee generally decreases. Thereafter, management fees are generally charged on net invested capital (often a smaller amount than committed capital) and may include a step-down, or lowered rate, after the initial investment period. A common step-down rate is a 10% reduction.

These five questions are important to answer and should factor into your decision making, regardless of whether you consider yourself a seasoned investor or you're making your first foray into the private markets.

To learn more about types of funds and private markets more broadly, visit Hamilton Lane's Knowledge Center.

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