STATE STREET

No Going Back

New Realities in Private Markets

May 2023

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Contents

Executive Summary **1**

Chapter 1
New Challenges: Impacts of the New Macro Economic Environment on Private Markets **4**

Chapter 2
New Solutions: Next Generation Data and Technology **24**

Chapter 3
New Opportunities: Growth of Retail Investment in Private Markets **42**

Conclusion **50**

Bibliography **51**

Back to Contents

Executive Summary

Investors in private markets are being forced to adapt to new macroeconomic, financial market and geopolitical dynamics. In this challenging global environment, deep-rooted, strategic operational changes to the efficiency and effectiveness of investment operations, especially regarding data management and analysis, are more important than ever. Moreover, these changes can help position institutional investors for the opportunities ahead.

In this report, we examine the challenges investors in private markets are facing and explore potential solutions, with focus on emerging opportunities from tokenization and growing retail interest. Our findings are based on research and analysis by experts across State Street together with a detailed survey we commissioned of nearly 480 large institutional investors from around the world. Key findings include:

- Despite significant global headwinds, institutional investor interest is greater than ever. Three quarters of respondents to the survey said they were expecting to invest as much or more in private markets in the coming year. However, more than two thirds said higher interest rates meant the cost of leverage typically required for private assets was making the asset class harder to invest in, with more than half increasingly looking at traditional fixed income where they had previously incorporated private assets in their yield generating portfolios.
- New challenges are leading investors to rethink which private market assets are most attractive, with real estate and private debt potentially losing ground on private equity and infrastructure. However, it has also generated a new focus on deal quality. The appeal of any investment is its ability to offer above inflationary returns and private markets' growth over the last decade or two has been a testament to it. Nonetheless, higher inflation makes a higher return demand on each deal entered into. The current macro environment narrows the scope of opportunities available to investors placing them in greater competition both to get into deals and to offer their clients chances to do so.

- A far more competitive environment in private markets is increasing pressure on investors to seek an edge. Nearly two thirds of the respondents said improving their data management processes would confer a competitive advantage on them, but more than half also admitted to wasting considerable time and resources on manual data management and transfer processes. An over reliance on multiple, fragmented data repositories (often spreadsheets), and a failure to integrate technology systems, often acquired over many years, are the main culprits.
- Investors are eyeing long term opportunities in private markets. If the challenges to making retail investment in this area comparable to that in public markets can be resolved, it would generate significant new capital flows for asset managers and enhance the investment opportunities asset owners can offer savers. Respondents recognized this demand was growing and saw potential for digital tokenization to play a role in bringing retail investors into private markets. However, they were skeptical that the transition could be made in the near future, predicting the period of relatively scarce opportunities and increased competition outlined above would continue for several years.

The 2023 Future of Private Markets Study

Towards the end of 2022, we conducted a survey of nearly 500 investment institutions across North America, Latin America, Europe and Asia Pacific (APAC) to understand the outlook on private markets of generalist asset managers, private markets managers, insurers and asset owners. This has formed the basis of our 2023 Future of Private Markets Study, in which we analyze the macro environment and its relation to private markets, what is driving demand for private markets assets among retail investors, and the role of emerging technologies and new fund types. Additionally, we took a deep dive into the role of technology in addressing data management, efficiency and transparency.

Chapter 1

New Challenges: Impacts of the New Macro Economic Environment on Private Markets

Introduction: An inflection point for private markets

In the last 15 years, private markets have benefited from the low interest rate environment in place since the 2008 Global Financial Crisis, which helped keep borrowing costs low and fostered greater risk appetite among investors for higher growth assets.

After the stellar returns seen in public markets started to run out of steam, investors began turning to private markets in search of the next generation of growth companies. Demand for better returns fueled boosted allocations to private equity, while appetite for higher yields steered some investors to private credit and infrastructure.

The double hit last year of the world's productive capacity opening up after the COVID-19 shutdowns (during which demand was maintained through economic stimulus) and the Russian invasion of Ukraine stifling the production and export of a number of agricultural and other commodities have had a significant inflationary effect.

Our 2023 Future of Private Markets Study has confirmed what many people believe, that markets have reached an inflection point, and the era of cheap borrowing and low rates is over. These changes to the investment environment have significantly impacted how investors view private markets.

However, the research also shows that institutions continue to see value in private market asset classes and are willing to continue growing allocations to them, despite the difficult environment in which they now have invest. Private markets as a means of raising capital for companies and projects remains essential to the global economy.

The recent Silicon Valley Bank (SVB) collapse and the tremors it created in the bank lending market are a reminder of 2008 crisis and demonstrate the need for a diversified fund raising ecosystem in which capital markets, private and public, play their role alongside the banking system. However, the SVB story also raises a broader question underlined in our survey responses, that investor demand for increased transparency and better availability of frequent, trustworthy data is growing. Even in public markets, which have a head start in these areas, the old private market reporting procedures will need to change soon, to meet the demands of investors, institutional or retail.

The research also shows that institutions continue to see value in private market asset classes and are willing to continue growing allocations to them, despite the difficult environment in which they now have invest.

26 percent of respondents believe the new higher inflation investment environment will be short-lived and the tailwinds of low interest rates and quantitative easing that drove asset prices for much of the past decade will return.

A higher rate and inflationary environment will bring challenges for private markets.

More than half of traditional asset managers (61 percent) and asset owners (63 percent) believe higher rates will increase the relative attraction of traditional fixed income assets as a source of yield compared to private markets. Over two-thirds of respondents (69 percent) believe increased cost of borrowing will negatively affect the attractiveness of highly leveraged private assets, with asset owners (81 percent) feeling strongly about the impact of higher rates.

Despite these concerns, only one-quarter of respondents say they will allocate less to private markets because they do not believe they will outperform public markets or because the cost has increased.

While the conditions are quite different, the appetite for private market assets remains strong. Greater familiarity with the asset class has allowed investors to change how they use private markets within a portfolio.

68%

of institutional investors, including asset owners and insurers, plan to continue investing in private markets.

61%

of all respondents believe that private markets remain a good long-term investment.

How have economic conditions changed perceptions of private assets?

Greater investor familiarity with the asset class has changed the way investors look at potential barriers to entry; what were once considered to be major hurdles are now less of an issue for asset owners. A minority of respondents believed high fees, a lack of transparency and long lock-up periods were challenges to investing. Investors broadly accept that high fee levels are justified by the expertise required to navigate these complex markets, with only 29 percent of asset owners and 19 percent of insurers, calling this a concern. Similarly, lock-up periods are not considered long, with 32 percent of asset owners and 31 percent of insurers flagging the issue.

However, with greater familiarity of private markets investors have a better understanding of how they function and how best to incorporate them within a diversified portfolio.

Changing macroeconomic conditions have seen investors use private assets in different ways. In the 2021 State Street Private Market Study, diversification, returns and better yields were among the chief reasons for allocating to private markets. By 2022, respondents had become more concerned about how private assets could help them in an inflationary environment. 44 percent of respondents argued that the asset class could act as an inflation hedge within portfolios. More than half of all respondents (58 percent) said that they will favor private assets that deliver returns above inflation or act as a useful hedge.

Despite their recognition of the challenges presented by the macroeconomic environment, 68 percent of institutional investors, including asset owners and insurers, plan to continue investing in private markets in line with their allocation targets. 61 percent of all respondents believe that private markets remain a good long-term investment.

What do you think will be the impact of higher inflation and interest rates on how investors view investing in private markets?

	Overall	Traditional Asset Manager	Private Markets Asset Manager	Asset Owner	Insurance
The increased cost of borrowing will negatively affect the attractivenss of highly leveraged private market investments	69%	68%	54%	81%	72%
We will continue to allocate to private market assets consistent with our existing target allocation	68%	64%	65%	78%	64%
Higher inflation and interest rates will persist, but private markets are still a good long-term investment	61%	59%	69%	65%	49%
We are likely to favor private market assets that typically offer above inflationary returns (e.g., real estate) and are a useful hedge against inflation	58%	54%	68%	64%	48%
Higher interest rates will increase the relative attraction of traditional fixed income, compared to private market assets, as a source of yield	54%	61%	43%	63%	48%

Which private markets are garnering the most attention?

Although the wider investment backdrop has changed considerably over the past year, the most popular private market asset has remained unchanged. Private equity/venture capital remains the most popular type of private asset for all types of investors across regions. For some institutions, the challenging macroeconomic conditions of the past 12 months and volatility in public markets have provided an attractive entry point for private equity investors.

Overall, 62.5 percent of respondents say that they will invest the largest amount in private equity over the next two-to-three years. Support for private equity is strong in all regions, but strongest in APAC (69 percent) and North America (68 percent), regions with strong traditions in private equity.

The strongest advocates for private equity were private markets asset managers (70 percent) and asset owners (70.8 percent), support for private equity was particularly strong among family offices and endowments/charities/foundations.

While private equity will likely attract the greatest amount of allocations from European investors, there is also healthy demand for infrastructure assets, where investment has been growing in recent years.

Infrastructure will likely play an increasingly important role in investors' private market allocations. The study found almost four times the number of institutions planned on large increases compared to decreases over the next two-to-three years. Anticipated allocations to infrastructure are even larger than the net increase in allocations to private equity.

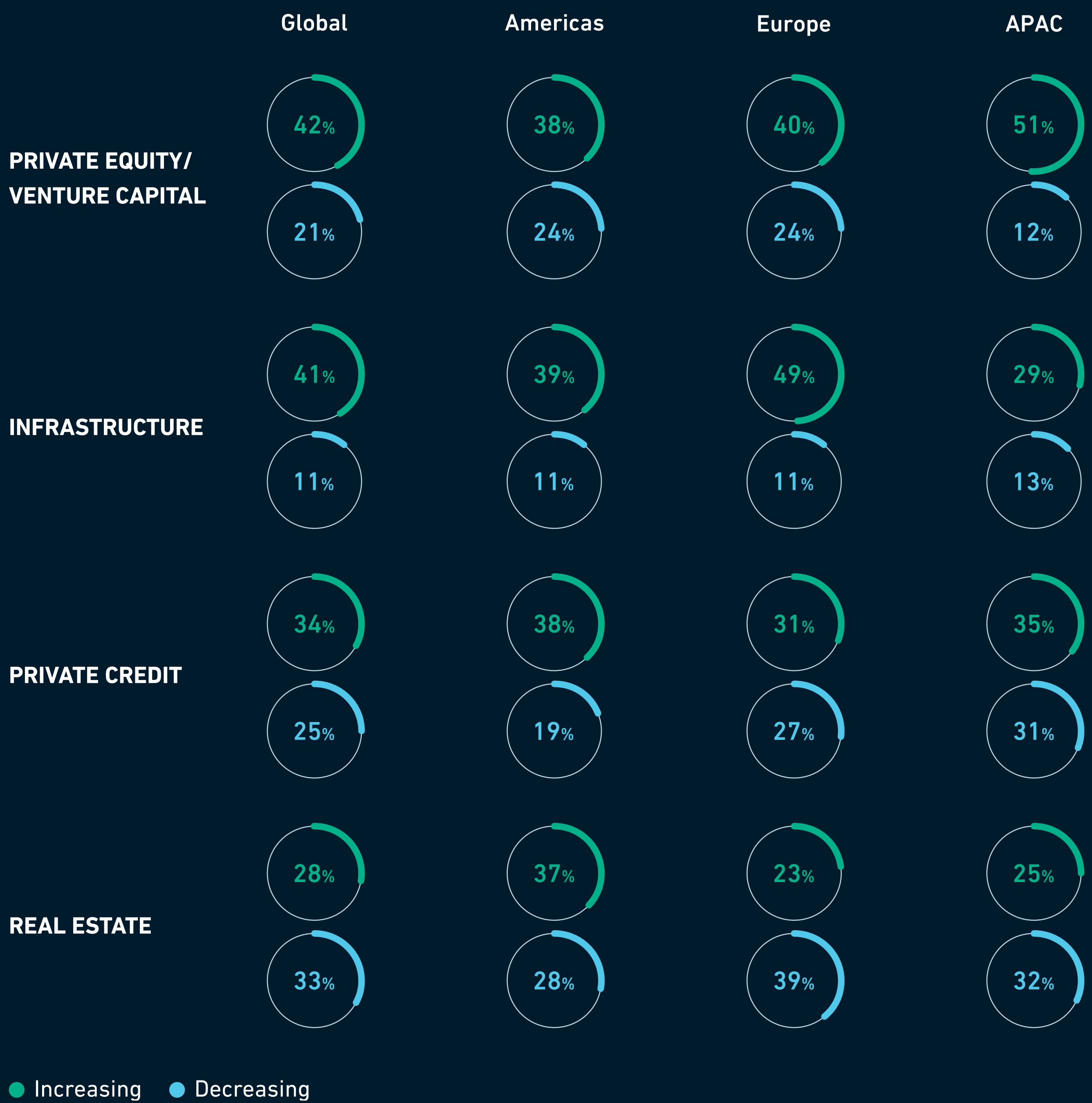
A net 39.2 percent of insurers plan on making the biggest allocations to infrastructure, followed by 35.9 percent of traditional asset managers. From an insurer's perspective, the asset class offers attractive long-term – and often inflation-linked – yields and exposure to more ESG-friendly assets.

On a regional basis, Europeans are most bullish on infrastructure, with 38 percent planning on a large increase to the sub-asset class. However, there is also strong appetite in North America – where private equity has traditionally held sway – where 35.8 percent of respondents anticipate making big allocations.

Strong appetite for infrastructure notwithstanding, there remains a considerable appetite for private equity, which will rise on a proportional basis globally by 21 percent, with very strong appetite in APAC (39 percent).

Which private markets asset classes do you anticipate increasing your allocations to by the largest amount, as a proportion of your current allocations? Select all that apply.

Which private markets asset classes do you anticipate decreasing your allocations to by the largest amount, as a proportion of your current allocations? Select all that apply.



Which private markets are out of favor?

While the changing macroeconomic conditions and market environment favor some private markets, not all have increased in popularity.

Private debt has been one of the beneficiaries of the low-rate environment in place largely in the last 15 years since the Global Financial Crisis, as institutional investors have sought higher yields. According to Prequin, since 2013, private debt assets under management have grown from US$439.3 billion to US$1.3 trillion as of 30 June 2022[1]. However, as interest rates have started to rise over the past 12 months, there are signs that appetite for private credit – one of the great growth areas in the low-rate environment – has waned. Heading into 2022, more than half of respondents (54 percent) to the 2021 State Street Private Market Study expected to increase allocations to private credit in the next three-to-five years.

Heading into 2023, only 43 percent of all respondents planned on making a higher allocation to the asset class in the next two-to-three years, the lowest of any private market asset. Appetite for private credit was lowest in Latin America, where only one-third (33 percent) planned to make a higher allocation. However, half (50 percent) of APAC respondents were keen on committing more money to the asset class.

Among asset owners, private debt remains popular with corporate defined benefit pension funds – with 69.2 percent planning on increasing allocations – and endowment, charities and foundations, half (50 percent) of which plan on adding more to the asset class.

For defined benefit pension funds with longer-dated liability payments to consider, some areas of private credit can offer stable and predictable income over the long term and an illiquidity premium, further enhancing yields.

Another private market that has witnessed significant decline is real estate. In recent years, the asset class has been one of the first to gate during times of greater uncertainty, such as the COVID-19 pandemic and Brexit, as investors have rushed to liquidate their holdings. With expectations of tougher economic conditions and a potential recession, some investors have argued the asset class looks overvalued with significant downside potential[2].

Our study highlighted real estate as an area from which asset managers and owners would be limiting their allocations in the coming years as a proportion of their total portfolio. One-third of respondents (33 percent) said they would decrease allocations, compared with 28 percent who would increase exposure to the asset class.

Investors in Europe were the most bearish on the asset class, with 39 percent planning on holding back their investments from the sector compared with 23 percent planning to add exposure. 32 percent of APAC respondents also planned on minimizing exposure to the sub-asset. Respondents in the Americas were most bullish about the asset class, with 37 percent planning on increasing allocations compared with 28 percent who planned to decrease their allocations.

Among asset owners, support for the asset class is weaker, with 31.7 percent planning to reduce exposure, compared with 27.5 percent planning an increase.

Michael Knowling

Head of Asset Owner
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State Street

Asset Owner Perspective

Allocation

We have seen a growing trend among asset allocators and owners – such as pension funds, endowments and foundations – making bigger allocations to alternative investments across the board. Some of this was prompted by changes in legislation. For example, in the US, public pensions are legally required to have private equity allocations at a certain level.

Asset owners are saying that they are interested in all private market assets. The only area where we have seen some pullback is real estate, which is more likely to be disproportionately hit by interest rate uncertainty.

There is also less appetite for leveraged strategies, as greater market volatility can significantly impact returns. Volatile markets have also highlighted the importance of manager selection, finding those with proven track records and understanding how they use leverage.

Fear of leverage generally has led to a slowdown in the secondary market, where asset owners have traditionally sought these strategies. There has been a greater willingness to make direct investments in private markets.

Operation

Some of the biggest challenges surrounding private market investing for asset owners are around data: managing it, ingesting it and analyzing it. Many asset owners rely on their service providers to help them augment data ingestion and management. For example, a lot of information and data comes in the form of physical documents, so a partner with machine learning capabilities that can validate data and make it usable is extremely important.

We have also seen a lot of talent mobility over the past 18 months. Indeed, industry turnover in 2022 was very aggressive, although it has slightly cooled down. There is a need for people with a background in private markets and operations because of the growing demand for data. ESG is another big data issue for the industry.

The available data is not easily comparable across the different areas of alternatives. If you want to understand the risk of an investment, you need to understand the characteristics of the underlying assets. Many providers are trying to figure out how to get ESG information from private investments, but it is extremely difficult to get valid data.

Democratization

There is growing interest in private markets, but the regulatory regime is not there right now. Regulators have not spent time analyzing how retail investors can invest in private markets because public markets have performed so well. But that could change.

There may be more activity in this space because public equity and fixed income markets have struggled. Last year was challenging for the average retiree; the traditional 60/40 asset allocation model simply did not perform. Therefore, regulators will have to speed up their work to figure out how they can open up private markets for retail investors, many of whom have invested in these assets through their pension plans.

Dry powder and new opportunities in private markets

The changing macroeconomic conditions and ongoing geopolitical uncertainty have pressured investors to liquidate investments in their portfolios, resulting in forced selling in private markets. Expectations of bargains to be had may explain why some asset managers have been hoarding dry powder.

Last year was one of the most active years of the previous decade for private equity transactions, according to EY[3], with transactions valued at under US$730 billion.

However, towards the end of 2022, private equity firms became increasingly cautious, with only 200 deals worth US$214 billion announced[4].

The value of dry powder estimated by private equity firms stood at approximately US$2 trillion towards the end of last year[5], a 21 percent year-on-year increase from the US$1.6 trillion reported in December 2021 by alternative assets data provider Preqin.

Opportunistic investors are beginning to sense there may be attractive returns. Three-quarters (75 percent) of respondents believe tougher conditions will lead to better opportunities.

Although forced selling could provide attractive investment opportunities, investors remain concerned about the dealmaking environment. Half of the respondents (51 percent) believe that private equity valuations have not yet adjusted to new market conditions, although private markets asset managers are less likely to think so.

What are your biggest investment concerns when investing in private markets today?

	Overall	Traditional Asset Manager	Private Markets Asset Manager	Asset Owner	Insurance
Private equity valuations have not yet adjusted to new market conditions	51%	59%	39%	52%	55%
A lack of information and transparency on private marktets in general	32%	36%	31%	30%	32%
Capital is locked up for too long	31%	36%	26%	32%	31%
Erosion of convenants on private debt and loans (e.g., Cov-lite loan structures)	21%	19%	18%	20%	28%
Overcrowding and competition for deals in certain private markets	48%	39%	52%	54%	47%
A private equity bubble risk generated by the falling revenues and profits of companies going to IPO	32%	32%	32%	30%	33%
High fee levels are not justified	26%	33%	24%	29%	19%

% Multiple answers allowed

72%

of private equity firms always screen target companies for ESG risks and opportunities at the pre-acquisition stage.

46%

of private markets asset managers believe private markets are better for ESG than listed markets.

Another significant challenge for investors is overcrowding and competition for deals in private markets, which was flagged by 48 percent of respondents. It is something that more than half of private markets asset managers and asset owners are concerned about.

The case for private markets in an ESG portfolio

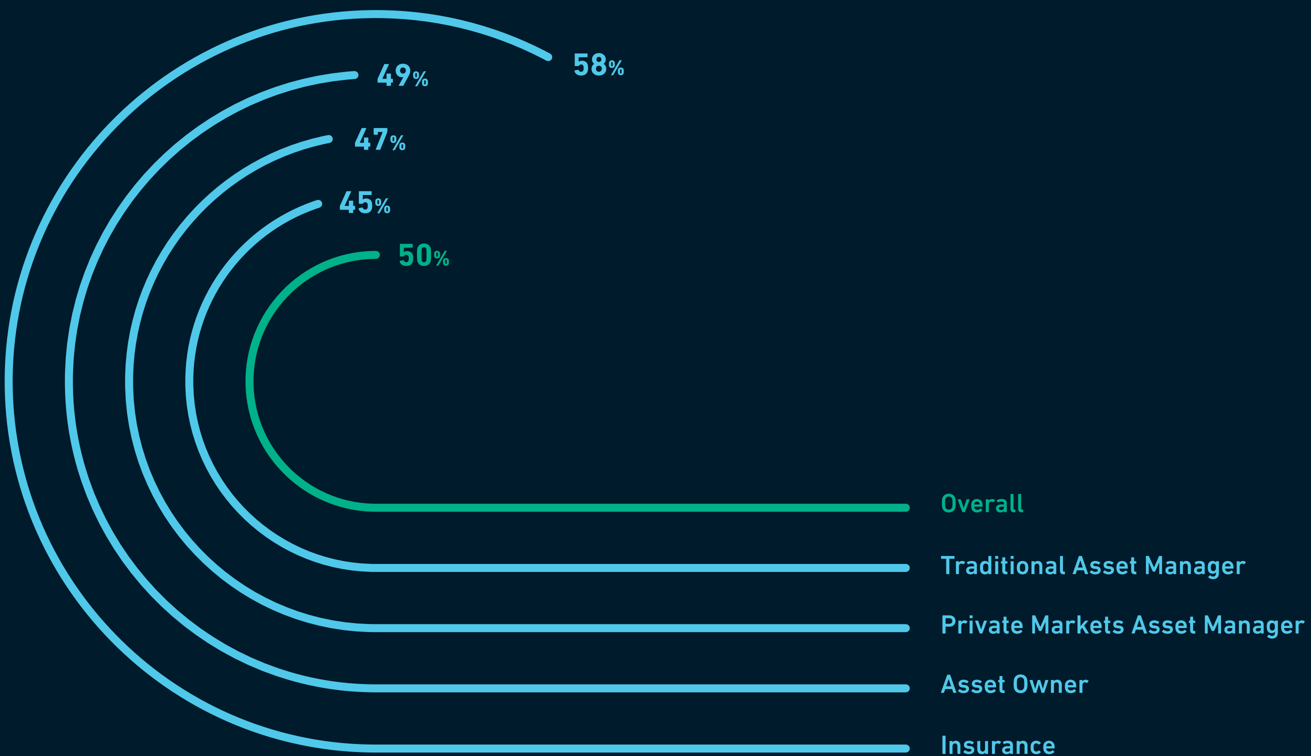
The growing popularity of ESG strategies in traditional asset management has been well-documented, but the trend is yet to become fully embedded in private markets. Nevertheless, private markets have made significant strides in the ESG stakes in recent years. And investors are starting to recognize how private markets can play an increasingly important role in their ESG strategies.

In private equity, ESG has become an increasingly important consideration when investing, according to consultancy PwC. Some 72 percent of private equity firms always screen target companies for ESG risks and opportunities at the pre-acquisition stage, and over half (56 percent) have refused to enter general partner agreements or turned down investments on ESG grounds[6].

Indeed, half of all respondents (50 percent) believe private markets provide better opportunities for ESG impact than public markets, including 58 percent of insurers and 49 percent of asset owners. 46 percent of private markets asset managers believe private markets are better for ESG than listed markets; this rises to 60 percent for private debt managers.

To what extent do you agree with the following statement on private markets at this time (percent agreeing)?

Private markets provide a better oppurtunity than publlic ones to make an ESG impact



Managers will likely face greater scrutiny as more investors turn to private markets to fulfill their ESG commitments. Around two-thirds of all respondents (63 percent) believe it will be one of the most scrutinized areas, with 68 percent of asset owners believing so.

While scrutiny will increase, it is likely to focus on specific areas. Environmental and/or social components will likely receive greater scrutiny (57 percent) than governance (41 percent). Furthermore, carbon emissions will also be important for respondents, particularly for insurers.

To what extent do you think this increased transparency will apply to ESG within private markets investments specifically?

	Overall	Traditional Asset Manager	Private Markets Asset Manager	Asset Owner	Insurance
ESG in general will be one of the more scrutinized areas of private markets transparency	63%	63%	58%	68%	62%
The Environmental and/or Social elements of ESG will receive the most scrutiny, in a more retail oriented market of private assets	57%	52%	61%	53%	62%
The carbon emissions (and/or contributions to a Net Zero goal) will receive the most scrutiny in a more retail-oriented market of private assets	53%	52%	53%	48%	60%
ESG in general will be an area of data/ transparency scrutiny in private markets, but not an area of greatest scrutiny	51%	48%	42%	56%	57%
The governance aspect of ESG (especially around corporate ownership and decision making) will receive the most scrutiny, in a more retail oriented market for private assets	41%	44%	39%	40%	42%

On a regional basis, there is support for greater scrutiny from European investors from two-thirds (66 percent) of European respondents, having been early adopters of ESG investing, compared to over half (57 percent) of North American investors.

Nevertheless, it remains to be seen how the industry will overcome the challenges of data and transparency that will allow more ESG investors to participate in private markets.

The potential of secondary private markets

As investors seek opportunities and bargains in private markets, there is one obvious area where they could begin looking: secondary markets.

Around two-thirds (65 percent) of total respondents believe that current market conditions will force investors to sell private assets in secondary markets for liquidity purposes creating buying opportunities. Interestingly, three-quarters (76 percent) of asset owners agree, perhaps suggesting that some may have already had to raise liquidity this way.

64 percent of respondents believe that secondary market investments offer attractive features for investors (such as avoiding J-curve effect and offering an earlier return of capital), but 41 percent say they have yet to use secondary markets despite interest. Furthermore, half (51 percent) say they plan on taking advantage of buying opportunities in secondary markets over the next year.

Despite strong appetite for secondary markets, professional investors face several issues, with 91 percent of all respondents facing at least one challenge.

To what extent do you agree with the following statements (percent agreeing)?

	Overall	Traditional Asset Manager	Private Markets Asset Manager	Asset Owner	Insurance
Current market conditions will lead to some investors having to sell private market assets in secondary market (e.g., for liquidity), creating buying opportunities	65%	66%	55%	76%	64%
Secondary markets are an important tool for better portfolio management in private market assets	65%	72%	55%	67%	67%
We plan to take advantage of buying opportunities in secondary markets for private assets over the next 12 months or so	51%	46%	57%	48%	52%
Secondary markets aid price discovery by combining market perception with an asset's supply/demand curves and transforming into a market clearing price	55%	58%	55%	59%	48%
Infrequent pricing is a positive characteristic of private markets in volatile market conditions, however this benefit is being eroded by the growth of secondary markets	33%	34%	30%	27%	40%
We are interested in using secondary markets for private assets but have not done so yet	41%	43%	45%	38%	39%
Secondary market investments have some attractive features for investors (e.g., avoiding the J-curve effect and an earlier return of capital)	64%	69%	68%	66%	54%

What are the biggest hurdles for your organization to using secondary markets for trading private market assets?

	Overall	Traditional Asset Manager	Private Markets Asset Manager	Asset Owner	Insurance
There are big gaps in the validations between would-be buyers and sellers	44%	47%	41%	43%	45%
Difficulties in doing due diligence on secondary market transitions	41%	43%	37%	43%	41%
Lack of well-developed secondaries outside private equity	38%	32%	48%	43%	30%
Inadequate supply of suitable or attractive private market assets via secondary markets	30%	39%	32%	23%	28%
Lack of familiarity with different options for secondary market transactions	28%	26%	28%	21%	36%
We lack the networks and contacts to find good secondary market transactions	25%	23%	23%	24%	30%
We are not facing any hurdles	6%	3%	5%	10%	7%
My organization does not use and does not intend to use secondary market for private assets	3%	3%	0%	7%	1%

% Multiple answers allowed

The biggest overall concern highlighted by 44 percent of respondents was huge gaps in valuations between would-be buyers and sellers, the major concern for traditional asset managers. Another significant issue raised by 41 percent of respondents was the difficulty in performing due diligence on secondary market transactions.

38 percent of respondents also stressed the lack of well-developed secondary markets outside of private equity, a challenge for 48 percent of private markets managers and 43 percent of asset owners.

Although the investment backdrop has changed substantially in recent years, appetite for private markets remains stable. As awareness and understanding of the asset class have grown, the use of private assets has become more sophisticated as investors use all the tools at their disposal to construct resilient portfolios.

Private equity remains one of the most sought-after assets within private markets, but investors are increasingly open to emerging areas, like infrastructure, that can offer different investment characteristics. However, the changing investment backdrop and increased market uncertainty have weakened the appeal of real estate and private credit. Nevertheless, there will be opportunities in both primary and secondary markets for investors with dry powder, as greater uncertainty and market volatility lead to forced selling.

Finally, having become well-established in traditional asset management, ESG investing could play a significant role in private markets in the years ahead and open up the asset class to a new cohort of investors.

Jesse Cole

Global Head of
Private Markets Product,
State Street

Private Markets Manager Perspective

Private markets have been core to the needs of institutional investor segments. In recent years, private market has witnessed several new product launches across client base and a growing demand for asset servicing across asset classes.

However, in uncertain times, growth might not follow as linear a path as it might have enjoyed in the past three years. As adoption increases, private market is expected to be reshaped as well.

Macro-economic scenario would shape how institutional clients allocate to specific asset classes and timing the market. For instance, private credit is a growing area as compared to private equity. Infrastructures continue to be an opportunity area.

Despite the macroeconomic headwinds, both investors and asset managers see merit in being invested in private capital. From an investor perspective it is an opportunity for risk diversification, access to private asset classes, and more holistically manage the portfolio risk. For asset manager, it is an opportunity to diversify how they raise capital.

Since institutional investors are experiencing this market dynamic for the first time after a long time, they need to think through having the capabilities and tools to choose the right manager, right investments without taking too much risk, and achieving the overall portfolio diversification.

The uncertain financial markets and pick-up in inflation are prompting even retail investors to look beyond the listed asset categories. This peaking interest is met with support and resistance in equal measure. The question is not about 'if' but 'how' to make private markets accessible to retail investors balancing the level of sophistication and liquidity of the product. It is important not to react to democratization pressure in a haste and work towards developing the right infrastructure, safeguards and regulations. Addressing liquidity and data transparency would be key to make private markets suitable for retail investors. Lack of data transparency remains as a key huddle to operate within private markets. Several factors contribute to this mounting challenge.

Historically, private market has been exclusive and largely been the preserve of institutional investors and high net worth individuals. Developing an operational infrastructure was not a focus area. However, now with increasing adoption, institutions are realizing the need to scale up their infrastructure.

Each asset class within private market is distinct and its structure is complicated. Most firms lack the resources and know-how to scale. Having the domain expertise is key to scaling up.

With respect to data management, data collection or normalization is not the hardest part. It is time to think about creating a universal data model for each asset class with a governance mechanism that would allow users to validate against use and harness the information across portfolio including public assets. Service providers have an opportunity to add value by bridging the data across credible sources to the needs of the users.

Today, institutions spend considerable amount of time and efforts around managing risk, investment analytics and forecasting, and layering in ESG. Investors and managers need private market data available through APIs or such mechanisms and retain the flexibility to run their own analysis within their functions such as risk management, compliance or investor relations. Data not only limited to investments but investors as well. To enable better data, investor reporting needs to modernize.

Each of the institutional segments are different. They have different infrastructure, business and regulatory requirements. Service providers are at unique vantage point to understand the challenges from diverse perspectives and take a leadership role in developing solutions holistically.

Back to Contents

Chapter 2

New Solutions: Next Generation Data and Technology

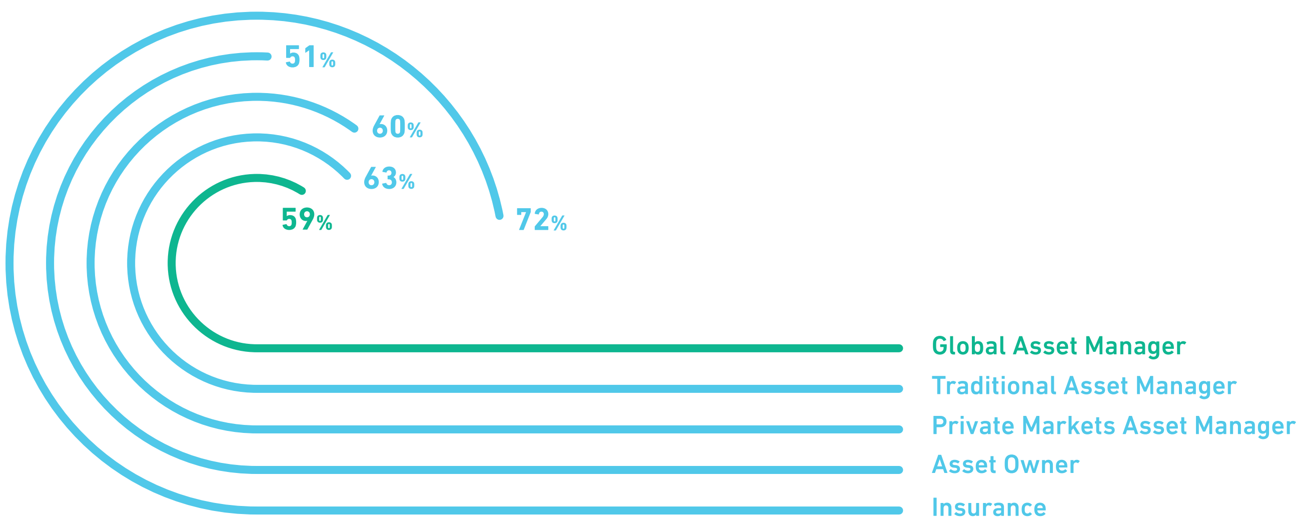
Introduction: Acknowledging, then meeting, the macro-economic challenge

Despite all the challenges outlined above, institutional investors continue to view private markets as a growth engine. Democratization of private markets may further the growth momentum in the longer term, by unlocking retail access. Are institutions prepared for the next phase of private markets growth? The survey data shows that they recognize many solutions lie in improvements to their data management and analysis capabilities. In particular, process automation and standardization of inputs, outputs and formats are seen as not just areas that could be improved, but ones that must in order to maintain a competitive position in the deal identifying and selecting landscape (as well as in the sales and distribution landscape for managers). However, technology and systems alone were only part of the story. Improvements need to be part of a process of internal reform, in which data is better integrated through the front, middle and back office operations of the organization, with skilled and dedicated data staff managing data use and strategy on a holistic basis across the organization.

The growing recognition of the need for wide ranging data reform

Thinking about private markets data management, to what extent do you agree with the following statement?

Data management and analysis capabilities have become an important source of competitive advantage for our firm?



Institutions are waking up to the significant benefits that data offers as well as the serious challenge that the lack of a holistic data management solution poses. Several factors are accelerating this trend.

Key drivers include:

1 Transparency pressure from investors

A salient feature of private markets is that it is indeed private. With increasing private market adoption, Limited Partners (LPs) demand more accurate, frequent and detailed data to run their own investment analytics. Submitting a quarterly update in .pdf format is no longer the acceptable norm. They expect data in a specific format and with detailed focus on areas such as performance, fees, administration, etc.

2 Increased regulatory scrutiny

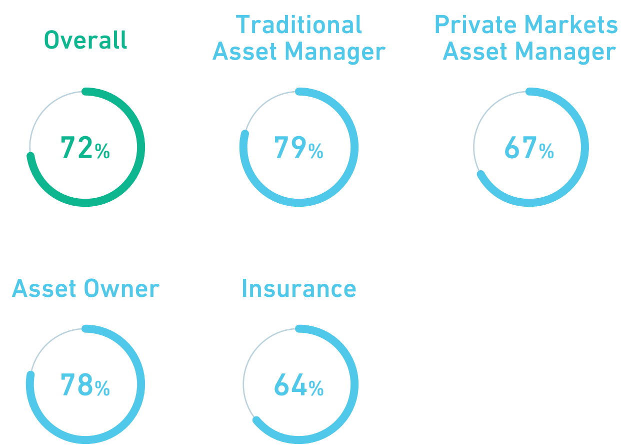
Regulators are tightening their oversight of private markets, demanding greater transparency in disclosures. This requires asset managers to implement more robust reporting tools and systems for private assets.

3 Mounting retail interest

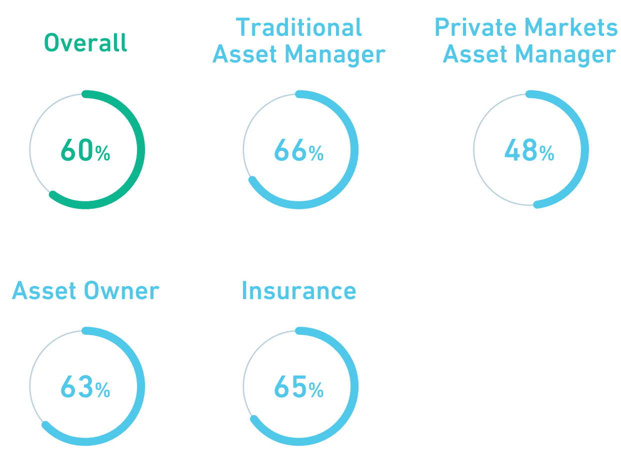
As the democratization of private assets continues, regulators across the globe work towards making available up-to-date valuations. Retail investors are accustomed to the high bar of transparency that public markets have set in terms of data quality and accessibility. Private market players need to significantly improve their current data management and reporting capabilities to meet their expectations on data transparency.

To what extent do you think this increased transparency will apply to ESG within private markets investments specifically?

If more retail investors access this asset class, governments and regulators will be compelled to demand greater transparency around private assets because of their investor protection duties



If more retail investors access this asset class, they will demand greater transparency around private assets



4 Sustainability push

ESG is a top priority for financial firms. For institutional investors and allocators to fulfill their commitment towards sustainability targets and net-zero initiatives, private market investing also needs to play its part – including consistent reporting standards around ESG metrics. Asset classes such as real estate and infrastructure need to improve their current capabilities to effectively measure and integrate ESG performance.

With the push for more transparency, nearly two in three institutions anticipate ESG to be one of the more scrutinized areas of private markets.

Thinking about private markets data management, to what extent do you agree with the following statements.

My organization is wasting a considerable amount of time and resources dealing with data because of manual processes and outdated systems

	Global Asset Manager	Traditional Asset Manager	Private Markets Asset Manager	Asset Owner	Insurance
ESG in general will be one of the more scrutinized areas of private markets transparency	63%	63%	58%	68%	62%
The Environmental and/or Social elements of ESG will receive the more retail oriented market for private assets	57%	52%	61%	53%	62%
The carbon emissions will receive the most scrutiny in a more retail-oriented market for private assets	53%	52%	53%	48%	60%
ESG in general will be an area of data/transparency scrutiny in private markets, but not an area of greatest scrutiny	51%	48%	42%	56%	57%

5 Concerns over illiquidity premium

Theoretically, illiquid assets command a return premium as investors bear the risk of illiquidity. However, private market managers have drawn criticism from mutual fund and hedge fund managers[7]. They argue that investors perceive less risk in private assets due to information asymmetry because the information offered by a private market asset manager is less frequent. Lack of information masks the day-to-day volatility of a private market portfolio, benefiting private asset managers.

In the next phase of growth in private markets, asset managers must address rising investor and regulatory expectations, enhance data transparency and integrate ESG factors effectively. However, this is not an easy task. The data management challenges in private markets are complex and not easily resolved.

Why the existing data operating models have to change

1. **Excel spreadsheets, though convenient, are limiting:** Analysts still use disparate Excel workbooks and outdated tools to collect and aggregate data. For instance, valuation models built on Excel have been an essential part of any private market deal. There is no standard template. The valuation of an infrastructure asset such as a solar farm, or a multi-property real estate portfolio versus a private credit or equity holding is different. So, each asset is managed within disparate excel spreadsheets by different analysts.

   These models are typically built bottom up and various departments such as finance, accounting, legal, etc. contribute to different sections of the model, making it extremely complex. With some back-dated information, these models can become cumbersome and even exhaust the number of cells available in an Excel spreadsheet.

   Now, imagine performing scenario / forward looking analysis on this spreadsheet model. A simple analysis such as understanding current portfolio exposure to a certain geographical area could take days because there is no central source of data.

Each analyst needs to run the scenario for their respective assets and then develop a portfolio view. In one of our earlier surveys[8], nearly half of asset managers said it takes up to a week or more to get a fund NAV. More than half (51 percent) of asset managers and 85 percent of asset owners estimated a week or more to run scenarios across their portfolios.

The manual approach to data management through spreadsheets and workflow via emails takes a long time to deliver even basic information to investors.

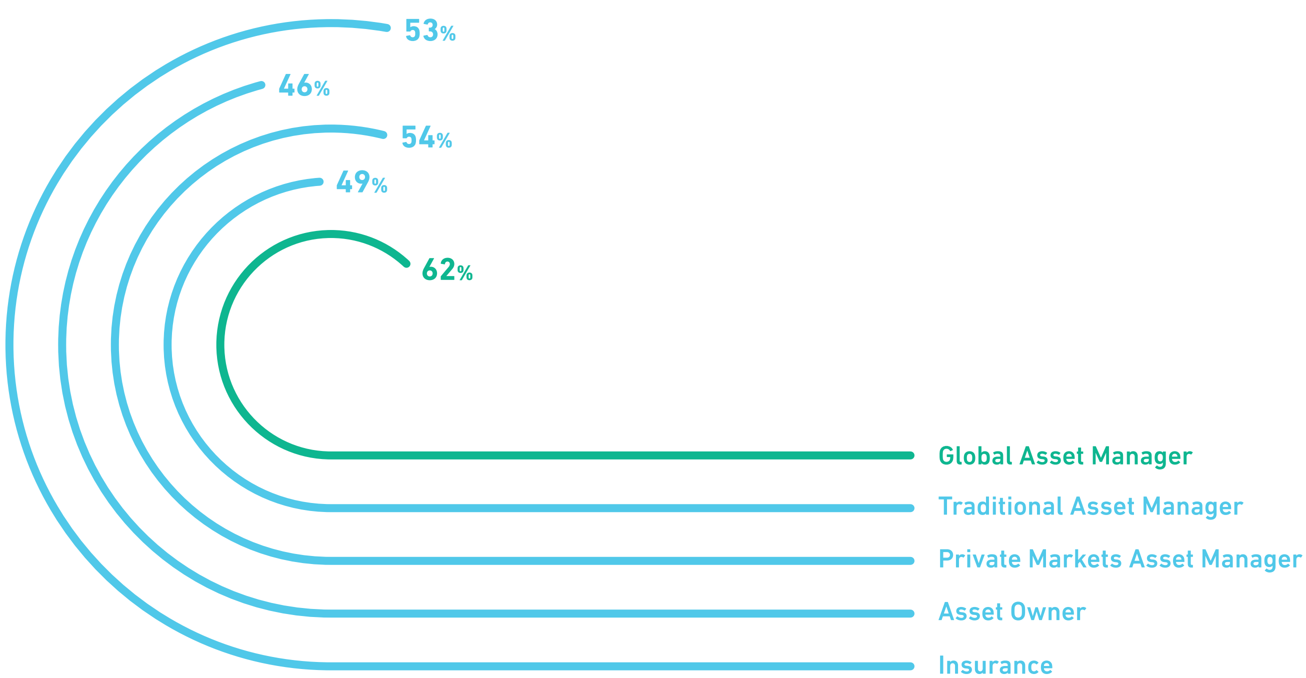
Our survey results indicate that more than 50 percent of institutions believe that they waste considerable resources in dealing with data because of manual processes that rely on Excel spreadsheets and outdated systems.

Standardization and automation of reporting can unlock significant efficiency gains.

There is an increasing realization that scaling up across portfolio could be harder if the data management technology cannot keep up with additional demands for information or iterations.

What are your biggest operational/implementation concerns when investing in private markets today?

My organization is wasting a considerable amount of time and resources dealing with data because of manual processes and outdated systems



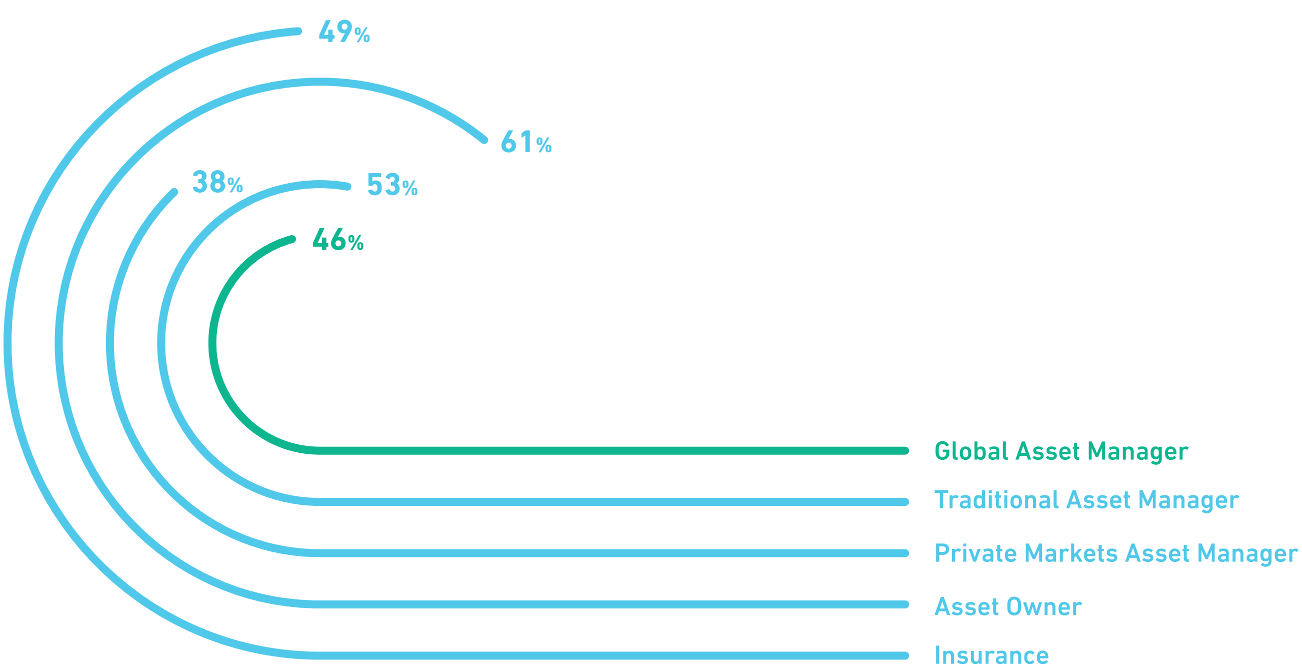
2. **Lack of confidence in reported data:** In addition to manual processes, the private market suffers from a lack of data accuracy and reliability. Normalization and standardization of data across asset classes could vary as organizations use their own definitions and reporting methodologies. Lack of historical data could affect the completeness of data analysis in some cases. Moreover, the resource intensive nature of operations could make the analysis error prone.

Hence, LPs do not feel confident when they receive an analysis as they cannot verify its accuracy or compare it to any references. Data transparency remains one of the biggest challenges in investing in private markets.

Transparency of data/information related to private markets is the number one operational concern when investing in private markets.

What are your biggest operational/implementation concerns when investing in private markets today?

Transparency of data/information relating to private market investments



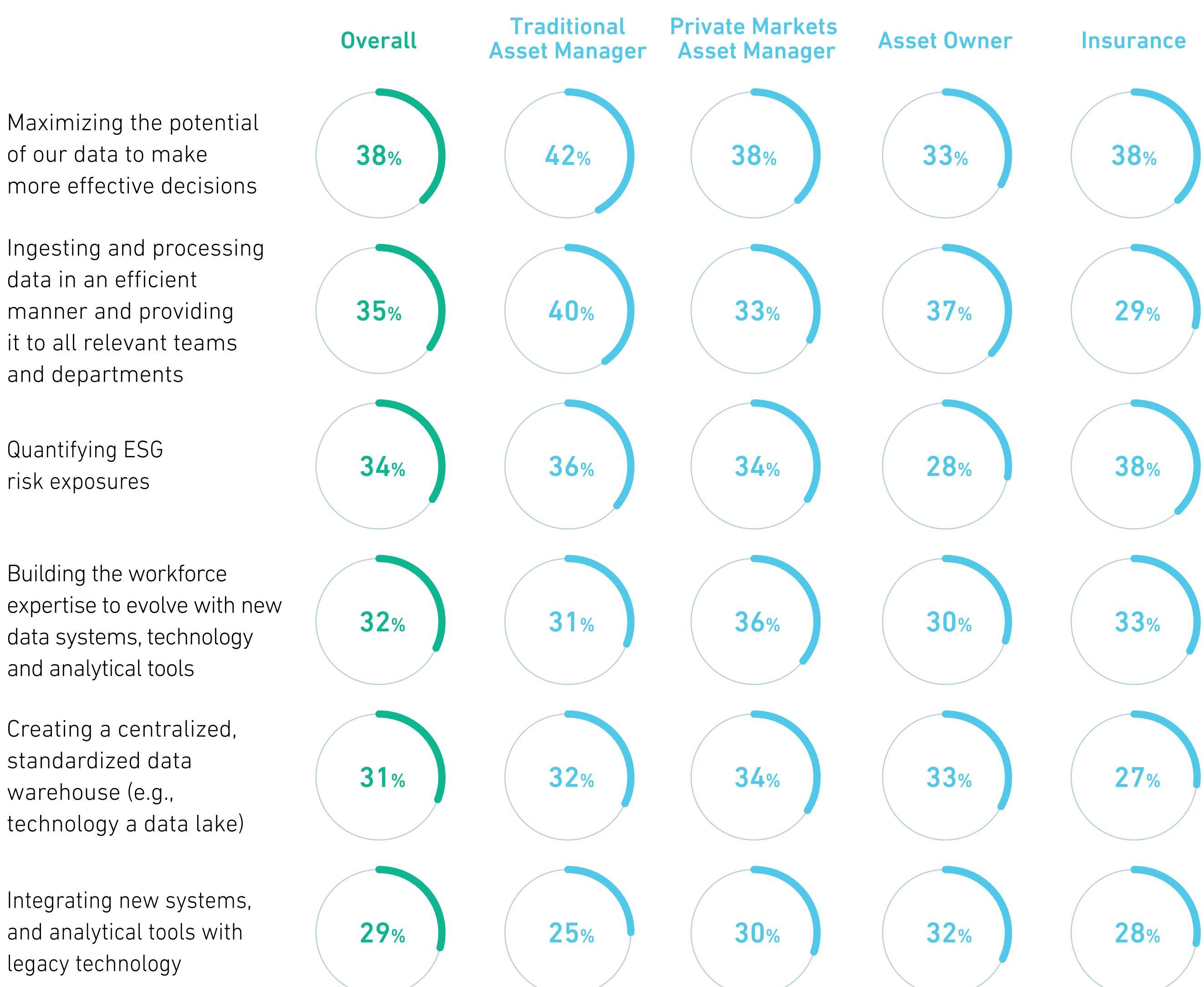
With the growing volume of data and multiple sources, the need for better standards of data governance and controls are going to be paramount.

3. **Narrow vision towards data management solutions:** Data challenges in private markets are not new. It is convenient to stick to the status quo and build quick fixes over the legacy processes. In the private market space, institutions have prioritized developing point solutions that can meet an immediate LP demand or a compliance deadline.

As private markets evolve, these solutions proved to be inadequate in providing a holistic solution.

According to our research, only 40 percent of respondents believe their data management capabilities are developed to meet the current requirements of the private market landscape.

Please indicate how well developed the following areas of private markets data management and reporting are in your organization?

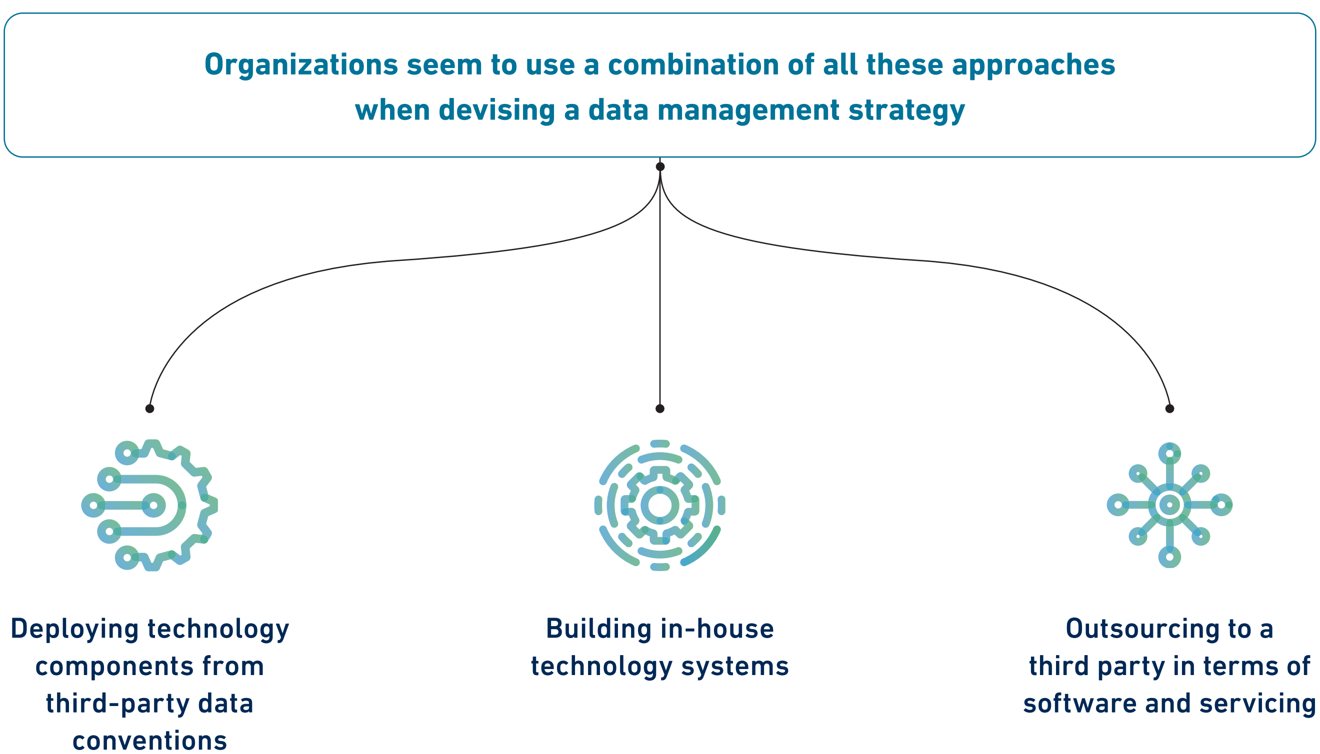


Of course, there is a cost to sticking to an antiquated data model or a point solution. For one, it is resource intensive and can make it difficult to obtain a unified, overall portfolio view for both asset managers and asset owners. Today, most institutions that invest across private and public assets, report those assets separately. With increasing allocations to private markets, a top-level view to understand the risks and opportunities at public-private portfolio level can bring significant efficiencies.

A holistic data management solution is a long-term investment and is expensive. McKinsey estimates that private market managers with more than US$10 billion in assets under management typically spend between US$1 million and US$5 million per year on third-party solutions and software per asset class[9]. Factoring in related spend on internal capabilities and talent, leading managers are investing more than US$10 million annually.

Organizations seem to use a combination of all these approaches when devising a data management strategy.

Large institutions with inhouse technology departments often opt for an in-house system. However, it is later that they realize the additional cost of maintenance, compliance, cyber security, etc., which creates a dent in their ROI calculations. It is imperative that organizations seriously think through potential costs and benefits before finalizing their approach.



4. **Underestimating the change management effort:** Onboarding a data management platform does not solve all the challenges. A holistic solution is a long-term commitment both in terms of cost and effort. Hence, transition management and change management investment are essential to the success of the data management implementation.

Pain points that need the most urgent attention

Data management has emerged as a competitive advantage for private market firms as they seek specific solutions that can fuel the next phase of their growth. While data collection is important, the ability to normalize and utilize data at scale is essential.

Our survey identifies that a significant share of traditional asset managers and asset owners identified structured data management processes as critical to maximizing returns.

Thinking about private markets data management, to what extent do you agree with the following statements?

Managers need highly structured data management processes in order to maximize returns

As organizations begin to have more mature conversations about data management at a holistic level[10], we asked leaders to identify the right data management capabilities and how to prioritize them.

The survey revealed that traditional asset managers place greater importance on data-related functions than peers. Nearly three-quarters of traditional asset managers indicated that integrating new technologies and tools with legacy systems is critical in private market data management and reporting space.

In contrast, private market asset managers assign greater importance to ingesting, processing and distributing data efficiently and centralized data storage. Quantifying ESG risk exposure is critical for insurance companies.

Please indicate how important the following areas of private markets data management and reporting are in your organization?

	Overall	Traditional Asset Manager	Private Markets Asset Manager	Asset Owner	Insurance
Maximizing the potential of our data to make more effective decisions	61%	71%	46%	68%	60%
Ingesting and processing data in an efficient manner and providing it to all relevant teams and departments	59%	63%	59%	58%	57%
Quantifying ESG risk exposures	56%	60%	44%	50%	69%
Building the workforce expertise to evolve with new data systems, technology and analytical tools	57%	66%	48%	58%	55%
Creating a centralized, standardized data warehouse (e.g., technology a data lake)	55%	22%	54%	60%	54%
Integrating new systems, and analytical tools with legacy technology	60%	73%	50%	58%	57%

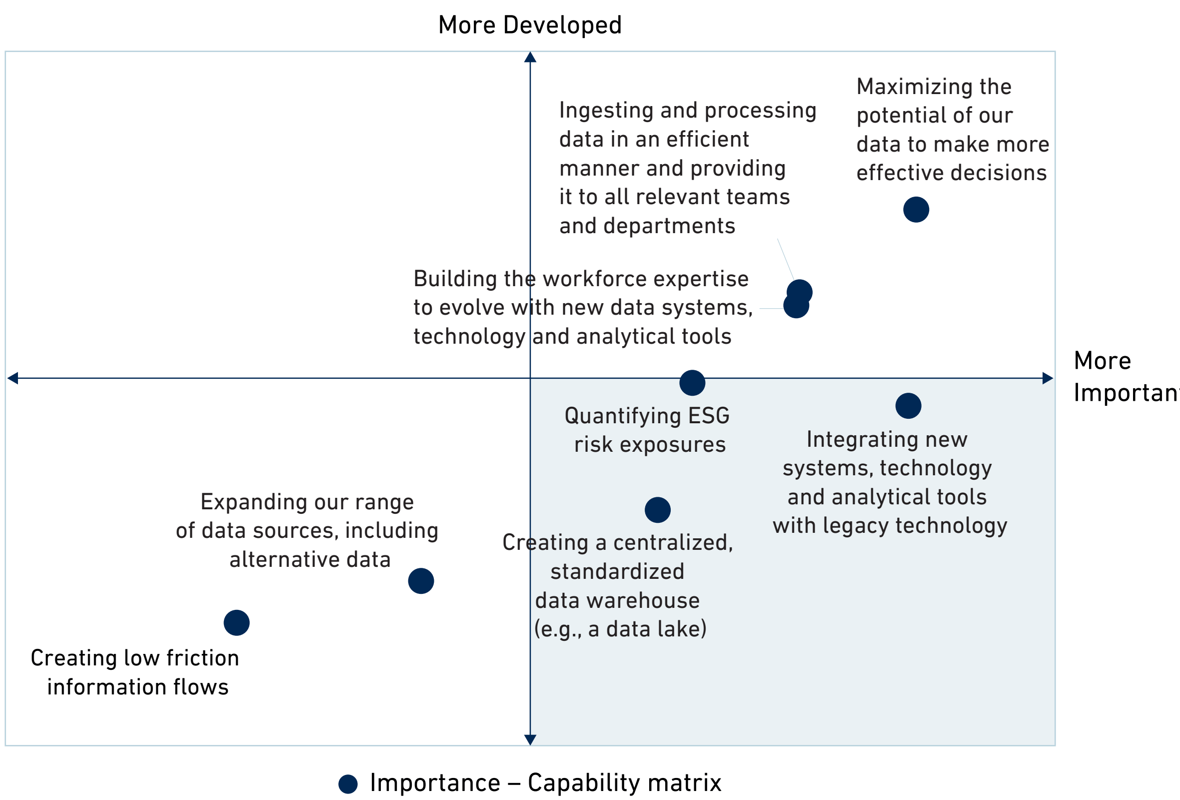
Institutions must regularly identify and prioritize the competencies that support their specific investment strategies and propositions.

The next step is to assess how developed these data management and reporting competencies are within their private market operations. None of the segments reported high level of sophistication in their current data management capabilities. While this is not surprising given that private market is still at an early stage of data technology maturity, institutions must improve their data management capabilities now to capture the next phase of growth. This is a tipping point to transform data management capabilities into a competitive advantage.

It is also crucial to make these insights more actionable by mapping the competencies – according to their strategic importance and level of maturity.

Please indicate how important the following areas of private markets data management and reporting are in your organization?

Please indicate how well developed the following areas of private markets data management and reporting are in your organization?



Global institutions indicated three critical data management and reporting priorities that are currently underdeveloped.

1 Integrating new systems, technologies and analytical tools with legacy

Organizations can tremendously benefit from the ability to harness the tenured and the new data at scale across assets in their portfolio. Integration is a foundational element in data solutions. Having an integrated platform can enable institutional investors with quick access to insights, performance, opportunities and risks. An integrated platform allows managers to access data and fund servicing specialists for consolidated information, reporting and insights. An integrated data management platform should also improve access to flexible cloud-based asset management tools such as deal management, ESG reporting, investor relations and portfolio monitoring.

Mega managers are probably more advanced in their efforts to integrate meaningful ESG measures in their platforms by virtue of their size, their tenure and the scope of their investor base because a lot of push is coming from their investors [such as pension funds and insurers].

Gennell Jefferson
Head of Private Equity & Business Development for State Street Global Advisors[11].

2 Quantifying ESG risk exposures

Demand for transparency and increase in regulatory reporting has spurred institutional investors to take a hard look quantifying ESG impact of their private market investments. LPs expect GPs to evaluate their investments and demonstrate ESG performance through data instead of assurances.

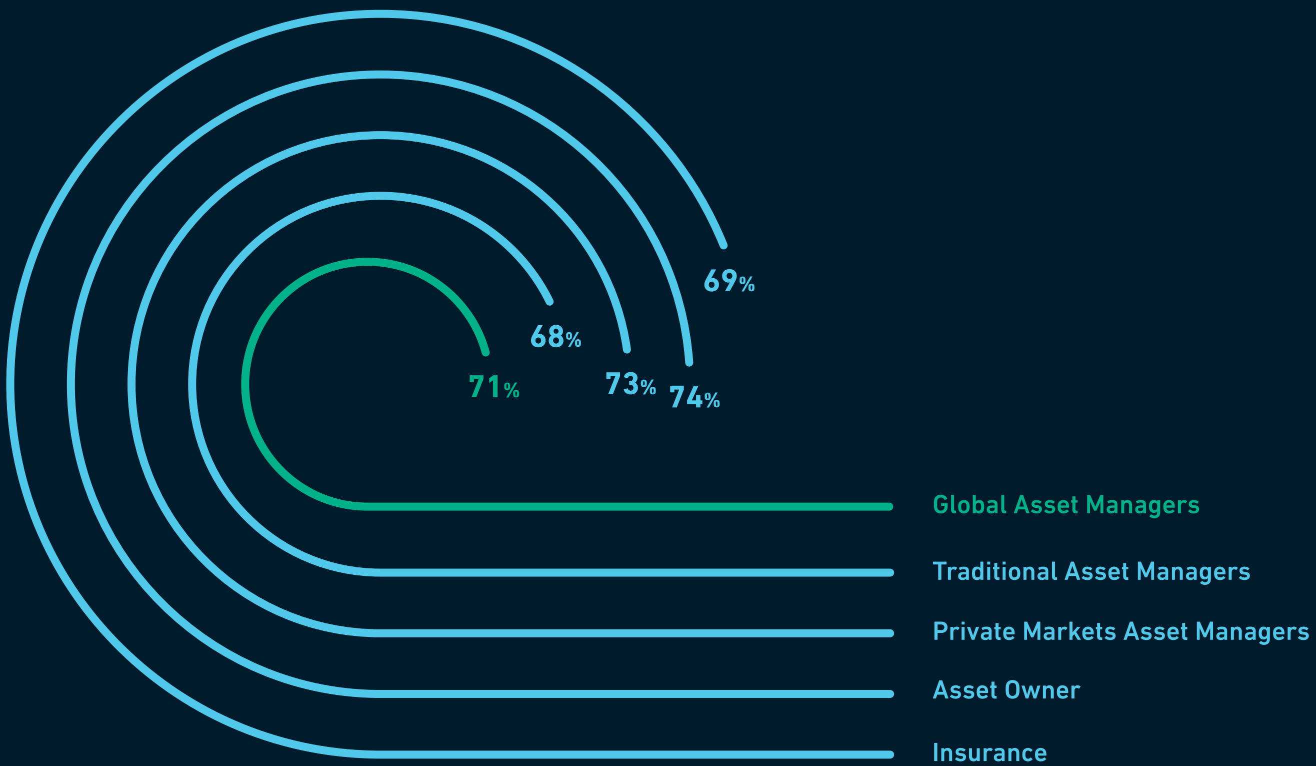
3 Creating centralized, standardized data warehouses

Developing a single source of truth is critical for institutions when they scale up. This can serve as a golden source of data, which can be pulled for many use cases including investment analytics and regulatory reporting. Centralized data warehousing and access to cloud can save time and provide flexibility as the private market landscape evolves.

In the survey, 7 in 10 respondents say they are investing in cloud. Cloud based storage and computing is a key area for tech investments to improve operations.

Which of the following types of technology are you investing in with a view to improving your private market operations?

Cloud-based data storage and analysis



Institutional investors and allocators who successfully prioritize and develop data capabilities will gain a competitive advantage in the market.

For private markets, the data management tipping point is here, institutions must act now to transform their capabilities to a strategic advantage.

Michael Knowling

Head of Asset Owner and Insurance Segments, State Street

Insurer Private Markets Perspective

In recent years, insurance companies have increased their allocations towards private markets. This trend is expected to remain strong as insurers continue to seek portfolio diversification and higher and uncorrelated returns. Essentially, investing in asset classes such as private equity and infrastructure provides insurers access to new sectors and areas of the economy, which otherwise are unavailable through public market. Broadly, private markets have proven attractive to insurers seeking to optimize their portfolios while balancing a range of requirements such as their risk profiles, capital positions, underlying insurance liabilities and regulatory guidelines within which they operate.

Despite significant macro-economic headwinds and higher interest rates, insurers continue to find private markets attractive. Yet, in response to macroeconomic trends, they are likely to adjust their exposures within private asset classes. For instance, insurers may pull back on real estate, given the uncertainties around properties and the rental yield, relative cost of capital, and due to overall attractiveness of other asset classes.

Insurers are likely to explore secondary markets or consider alternate investment strategies such as coinvesting with GPs, direct investing, or even investing in niche markets with little competition for capital and where valuation fits their profiles.

For investors, private asset classes fulfill different roles in a multi-asset portfolio as compared to public assets/ traditional investments. Hence, insurance companies need to carefully consider the unique attributes of each asset class including liquidity, predictability of income and yields, impact of interest rates, credit risks etc., and adjust their investment approach. At the same time, insurance companies also need to review and redefine their risk management strategies to adapt to evolving market conditions. Insurers are expected to be selective in their investment choices and conduct thorough due diligence to identify the most appropriate opportunities.

In this context, data has a critical role in enabling effective investment decisions and driving efficient operations. Today, insurers face several data challenges within private markets:

- Unavailability of reliable and consistent data across asset classes
- Lack of data standardization across private markets, making it difficult to compare how various asset classes fit within their broader portfolio
- Challenges in data integration while managing and analyzing data across several sources such as internal systems, external data providers and third-party platforms
- Talent shortage: Private market is a complex asset class and requires specialized expertise/ resources to understand and analyze

Access to private market data and lack of transparency could be a major barrier to retail participation in private markets despite high levels of interest.

With growing adoption of private markets, insurers are continually evaluating and adapting their data management and analytics strategies to address these challenges. They are taking steps to improve data quality, reduce errors in data collection, automate repetitive activities, invest in technology and infrastructure, including cloud-based data solutions and implement stronger data governance standards and controls. Leading insurance firms are increasingly partnering with front, middle and back-office platform providers to augment their data and analytical capabilities and develop scalable solutions.

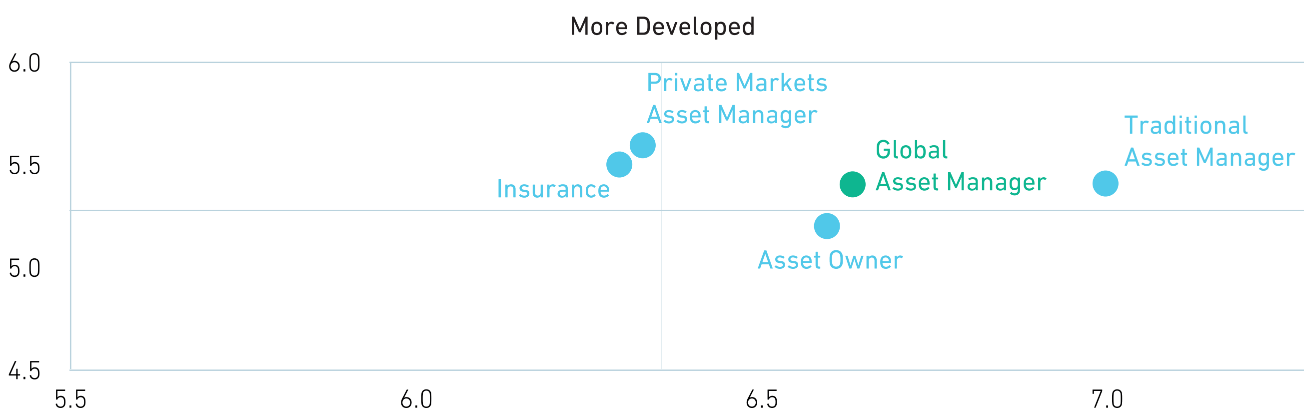
The private markets data skilled workforce model of the future

Our survey respondents recognized the importance of a combination of technological innovation and new or improved workforce skill as essential corollaries to making the improvements discussed above.

Technology is a key component in rationalizing the above data processes: in particular data lakes (where data from multiple sources is entered into an unstructured, cloud-based storage environment) in combination with a single interface capable of drawing specifically sought data from that pool (typically using some degree of artificial intelligence), performing essential analytics tasks with it, and displaying analyzed data in a dashboard where it can be compared in a variety of permutations.
The value of this kind of technology is acknowledged, but has some way to go, as data lakes are the least developed important area of operations across all respondent types, according to our survey.

The other element that is increasingly essential to success in this area is a workforce with the necessary skills, and an organizational structure designed to get the best out of them. In our survey, "building the workforce expertise to evolve with new data systems, technology and analytical tools," is high on the list of all institutions' priorities, with 59 percent calling it a priority. However, only 32 percent described themselves as developed in this regard.
The data also shows different respondent types had differing degrees of confidence in their staffs' and organizations' advancement in this area. Asset owners in particular were more likely to rate themselves as underdeveloped by this criteria, while traditional asset managers viewed it as particularly important.

Please indicate a) how important and b) how well developed the following areas of private markets – Building the workforce expertise to evolve with new data systems, technology and analytical tools – are in your organization.



Deal Management, Portfolio Management, ESG and Investor Relations are often very siloed groups, each with its own interpretation of data. The Data Quality Manager would create a critical organizational sponsor to ensure you get to a single source of truth that can be trusted.

Tom Vogt
Global Head of Customer Success,
Mercatus[13]

Just as the data lake and analytics technology being invested in by investment institutions is aimed at offering increasingly holistic views of an organization's data, and enabling them to see and use multiple in tandem with each other, so is the idea growing of a dedicated team or division within the business with oversight over all data and data-related functions.

This is beginning to catch on, and appointing chief data officers (CDOs) or data quality managers is a rapidly increasing trend among financial services companies[12].

The growing popularity of private markets over the last decade or more has already created demand for specialist staff in the area that is stretching institutions ability to find and afford qualified applicants. Furthermore, this challenge has spread from the buyside[14] to other parts[15] of the investments and financial services ecosystem. As the demand for data specialists grows in the sector, these issues could potentially be accentuated, so early adoption of the data quality division strategy could be an advantage, while outsourced solutions where the role of the CDO is taken on by a third party may also be worth exploring.

Chapter 3

New Opportunities: Growth of Retail Investment in Private Markets

Introduction: An opportunity but not to be taken for granted

In a tough economic and competitive environment, as described in the previous chapters, new distribution channels and sources of capital inflows are clearly desirable to managers, while the shift in most global pension systems from defined benefit to defined contribution structures means demand among asset owners for more quasi-retail private assets vehicles is also growing.

The popularity of Real Estate Investment Trusts and other real asset funds marketed to retail investors shows the demand among individual investors. In our survey, institutions acknowledged the growth of retail demand for private market assets, with more than half of total respondents (55 percent) seeing "strong" interest in the asset classes from individual investors. Not surprisingly, fund selling institutions are most likely to witness this demand and among them, traditional asset managers, i.e., those likely to have retail clients, were more alert to it than private markets specific ones (64 percent and 59 percent respectively). Diversification (63 percent) and yield (59 percent) were what institutional respondents saw as the main drivers of demand from retail investors, while more than half (56 percent) also cited the growth of high profile privately owned companies and publicity surrounding successful initial public offerings (IPOs) as generating awareness of private equity as an attractive asset class.

In terms of the private markets asset classes perceived to be most appropriate for retail investors, real estate, where there has already been some penetration into the retail markets through Real Estate Investment Trusts (REITs) and open ended retail property funds, was the first choice of respondents (60 percent), followed by private equity (46 percent).

However, there are a number of obstacles to this growth, and its rate of increase cannot be taken for granted or expected to mitigate the structural problems in private markets investment operations outlined above that need to be addressed by better data and systems. This was clear from our research, where was a strong consensus that the current market and product conditions are not right to make mainstream retail access to private markets happen in the near term.

Only 29 percent of respondents felt that private markets would function similarly to public ones in terms of accessibility and liquidity within the next 10 years. Nearly three quarters of respondents (72 percent) said private markets need to become more transparent for this to take place, while two thirds (66 percent) said new products are needed.

72%

of respondents said private markets need to become more transparent for this to take place, while 66 percent said new products are needed.

To what extent do you agree with the following statements on the democratization of private markets (% agreeing)?

	Global Asset Manager	Traditional Asset Manager	Private Markets Asset Manager	Asset Owner	Insurance
There needs to be more transparency in private markets to make them suitable for retail investors	72%	77%	58%	73%	80%
There is currently a lack of suitable investment products and platforms for retail investors who want to invest in private markets	66%	69%	60%	74%	62%
There is strong demand from retail/DC investors for increased access to private markets assets	55%	64%	59%	53%	43%
Complexity/lack of transparency makes private markets unsuitable for retail investors and DC pension fund members	55%	53%	54%	52%	60%

Government support is growing for retail private markets

The private markets institutional participants are not alone in recognizing the current barriers to entry for retail investors. Governments and regulators in several jurisdictions have launched initiatives aimed at dealing with these transparency and liquidity issues.
In the European Union, the European Long Term Investment Fund (ELTIF) and the similar UK Long Term Asset Fund (LTAF) are government lead attempts to enable vehicles that can hold illiquid assets and be invested in by retail investors and defined contribution pension fund members, with a view to generating investment in domestic infrastructure and real estate projects. In the United States, the Securities and Exchange Commission (SEC) issued a consultation in 2019, on making private markets more accessible.

ELTIFs & LTAFs Explainer

ELTIFs were originally launched in 2015 as a means of directing cross-border European capital into certain long term useful investment projects such as infrastructure. In its initial announcement of the rules governing the funds, the European Commission (EC) defined appropriate assets for ELTIFs as:

"Unlisted companies needing long-term capital, such as infrastructure, notably in network industries such as transport and energy, but also social infrastructure (hospitals, schools and social housing). ELTIFs can also invest in certain listed small and medium sized enterprises (SMEs), real assets that need long-term capital to develop them, intellectual property and other intangible assets, as well as European Venture Capital Funds (EuVECA), and European Social Entrepreneurship Funds (EuSEF)[16]."

ELTIFs were initially required to have at least 70 percent of their assets invested as above.

Last year[17], the EC published a review updating rules for ELTIFs in a bid to increase uptake of the products. The 70 percent minimum asset level was reduced to 55 percent and the definition of acceptable assets was simplified to widen the pool of available real estate, infrastructure and private equity holdings available to ELTIFs.

The LTAF is a new authorized open ended fund structure structured to accommodate long term and illiquid assets. The fund will be regulated by the UK's Financial Conduct Authority (FCA). The LTAF can take various legal forms – Open Ended Investment Company (OEIC), Authorised Unit Trust (AUT) or Authorised Contractual Scheme (ACS). Firms who are authorized as a full scope UK Alternative Investment Fund Managers (AIFM) with permissions to manage an authorized AIF are allowed to manage an LTAF[18].

The creation of the LTAF forms part of a strategy of the UK Government and Bank of England to capture greater investment from DC pensions schemes into long term assets. The intention of the government is unlock hundreds of billions pounds held in UK institutional investors accounts and to drive the UK's recovery. There is a plan to change the UK pensions charge cap (currently 0.75 percent) on the default arrangement of certain employer pension schemes, which should encourage trustees of DC pension schemes to consider investing in long-term assets.

The design of the LTAF has been made to allow investment flows towards assets such as infrastructure, private equity and real estate from investors that have historically been hesitant to invest in long-term assets, despite such assets being in line with their investment horizons.

As these products and initiatives are relatively new, they do not seem to be high in the consciousness of either institutional or retail investors. When asked to what extent things like ELTIFs and LTAFs are drivers of retail demand for private markets, only 17 percent of respondents thought it was a factor, by far the smallest selection from the available options (by contrast the next lowest potential driver on the list was access to green infrastructure with 41 percent). Furthermore, when asked, "What do you see as the most suitable ways to invest in private markets for new entrants such as retail investors?" 30 percent said dedicated retail private market products such as ELTIFs/ LTAFs or others relevant to their markets. But this was below said mutual funds (48 percent), funds of funds (43 percent), investment trusts (33 percent) and ETFs (31 percent). The new structures did, however, gain preference over DC funds, which were seen as suitable by only 22 percent of respondents.

So far, uptake of these funds has been limited. For example, the assets under management of ELTIFs has been estimated by various sources, as between €2.4 billion and €7.5 billion, according to the European Fund and Asset Management Association (EFAMA)[19]. This data refers to 2021, and regulator the European Securities and Markets Association (ESMA) has recorded the registration of 84 ELTIFs since then[20], so it is plausible recognition of the vehicle will grow in the minds of investors, both institutional and retail, when thinking about private markets. However, given the current size of the market, the challenges of perception in our survey outlined above remain a factor.

Private equity bubble risk threatens retail growth

Another challenge to the growth of retail investment in private equity in particular is bubble risk. When asked about what they see as growing risks to private market investment, a significant minority of institutions (32 percent overall but, interestingly, also 32 percent of private equity managers specifically) feared this growth in retail interest in high profile private equity was indicative of a bubble in the asset class, in which increasingly unprofitable companies were being taken to IPO, transferring risk from the initial private investors into the public markets. There is evidence that unprofitable IPOs are growing more common. In 2020, only 22 percent of companies were profitable after their IPO[21].

Meanwhile, 81 percent of 2000 IPOs were of unprofitable companies (immediately prior to the .com bubble), dropping to an average of 50 percent over the next 17 years but rising to 81 percent again in 2018 (and incrementally increasing through the 70 percent from the mid-2010s)[22].

Signs of irrational exuberance have been noted in investor decision making in private equity and post IPO, especially in high profile tech stocks: "Many unprofitable companies with no earnings on which to base a multiple still have high valuations because investors are simply willing to pay at that price[23]." This has potential knock on effects for public markets, as evidence also suggests medium term (three year) returns on unprofitable IPO companies are lower than profitable ones[24].

Paul Fleming

Global Head of
Alternatives Segment,
State Street

Asset Management Perspectives On Private Markets

Allocation

Typically, three factors are driving interest in private markets: returns, income and diversification. There is greater acceptance of the liquidity challenges in private markets, and some products are becoming more transparent. Markets are now showing a greater willingness to pay additional fees to get better returns. This is opening doors for retail investors; private markets are not just for the uber-rich.

Generally, we have seen outflows from the mutual fund industry with new allocations to private markets. Private equity is the hottest asset in private markets right now, and much of the demand is driven by the potential returns on offer. Private equity has outperformed public markets by a sizable margin in recent years. Although there have been years also where performance has been considerably lower and there has been volatility, by and large, private equity has outperformed.

There is also growing demand for infrastructure in investments, but real estate and private credit might be less popular because of higher interest rates.

Operations

Liquidity has become a key consideration for investors. When the COVID-19 pandemic began in Europe, many real estate funds started to gate redemption requests because they could not easily sell holdings quickly enough. That is something tokenization may be able to help with.

There has been a move towards less liquid strategies in recent years, and the industry is moving towards structures and products that can accommodate those, such as interval funds, but there are operational challenges that the industry needs to address.

Demand has outpaced the ecosystem's ability to handle efficient data flows, but some tasks still involve operational inefficiencies and manual processing. Those have already been highlighted and will get fixed, but they are not there just yet.

There is a life cycle for many products and asset classes where, as demand increases, the noise and friction need to be worked out because of the demand for more efficiencies and the obvious risk of something going wrong and the expense associated with that.

Democratization

Retail investors are seeking returns and diversification. There is a lot of cash on the sidelines. If public markets dip a bit, it will put even more pressure on asset managers to find decent returns.

Technology has also helped significantly. Private markets investors used to be very large, but you are seeing improvements in technology that allow for smaller accounts and allow dollars to flow in and out of the private markets with greater frequency. Investors' cash is no longer locked up for extended amounts of time like it used to be.

Regulations will increase because of the Sophisticated Investor rule for private markets. An average retail investor is not a sophisticated investor in the eyes of the SEC. So, as you start going downstream, the products will have to become more regulated. And suddenly, they will start looking a lot more like a '40 Act fund requiring a certain level of rigor and scrutiny from regulators.

Is blockchain the answer to retail private markets?

One mechanism that has the potential to dramatically alter the liquidity and accessibility of private markets is the fractionalization of real assets in particular into tokenized securities to be held and traded digitally, using the smart contract and blockchain/distributed ledger technology that currently enables the market for crypto currencies and other digital assets.

Most institutions anticipated this becoming a mainstream part of the investment landscape eventually, but were divided on the likely timescale. A fifth (20 percent) expected this in under two years, while a further 38 percent of respondents said it would take an unspecified longer time than that, with the remaining 38 percent saying it was unlikely in the next decade. Most institution types thought real estate was the private markets asset class most suited to digital fractionalization (and this has been a common use case in digital finance for some years now[25]), with only private markets specialist managers disagreeing. More than half of them (53 percent, compared to 39 percent of the total) chose private equity and private debt (43 percent, compared to 35 percent).

One potential method for making private markets more suitable for retail investors is to create liquid digital tokens out of private assets ('Tokenization'), or fractional shares of large illiquid private market assets, using the blockchain/distributed ledger technology that underpins crypto currencies ('Fractionalization'). To what extent do you see this becoming mainstream over the course of the next two-three years?

	Global Asset Managers	Traditional Asset Managers	Private Markets Asset Managers	Asset Owners	Insurance
Likely (Likely + Very likely)	38%	38%	25%	46%	44%
Unlikely in the next 2-3 years but likely in the longer term	38%	37%	46%	38%	33%
Unlikely (Very unlikely + unlikely)	20%	23%	26%	12%	21%

But there is other evidence that institutions see private markets as the primary beneficiaries of digital tokenization. In a separate State Street survey of digital asset and finance preparedness[26], a similar respondent base to that of the private markets survey were asked the same question but with response options widened to other non-private market asset classes. Even with these additional options they chose private equity (51 percent) and physical assets (48 percent) and private credit (44 percent) as their top three, with public market fixed income (33 percent) the nearest asset class to the private markets ones.

In our study, the opportunity for retail investors to get access to these asset classes was one of the top potential benefits of digital finance, cited by more than half of respondents (54 percent), with only increased speed, liquidity and lower cost of trading getting chosen by more (59 percent). Interestingly, asset owners made retail access their top potential benefit of the technology (62 percent).

Digital investment technology was also seen as posing certain risks to institutions and their clients or members. Principally, cyber security and new regulation specific to the technology that would increase their costs with compliance obligations (both 55 percent). However, asset owners and insurers were also significantly more likely than managers to express concern about distortions to the long-term nature of private market assets, if they could be traded as simply and cheaply as public ones. More than half of each felt the trend could lead to pressure on privately owned firms to adjust their business strategies, or for infrastructure projects to be designed with quicker returns in mind, potentially reducing the appeal of socially or environmentally useful ventures.

Conclusion

The three chapters of this report are not isolated topics. The macroeconomic headwinds facing private markets and the growth of retail clients for private markets funds and securities create a very real need for institutions investing in these asset classes, on behalf of clients or members, to make profound changes to the way they operate, especially in their use of data, across their organizations.

Manual systems for storing and analyzing data that comes from varying sources and generated using various standards are being discarded throughout financial services and the investment industry. In private markets, the complexity and volume of data required make this simultaneously more difficult but also more necessary.

This coming together of technological advancement with economic necessity has created an inflection point for institutions investing in all the private markets asset classes. The desire of investors to continue to grow their allocations to these assets is tempered by their acknowledgement that it is no longer as easy as it was, and nor will it be in the near future. Meanwhile, retail money, while a realistic source of capital in the future if the right circumstances continue to develop, are not an immediate solution to organizations' structural problems. So, the only way forward is improvement to operations and processes, and this means significant advances in investment in efficiency, technology and skills.

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