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A BIGGER ROLE FOR ACTIVE

BlackRock

The private markets perspective

In the current regime of higher interest rates and greater macro and market volatility, we believe there is **a bigger role for active strategies** and more opportunities for skilled managers to find and deliver active returns.

Key takeaways

Private equity can enhance returns

Longer holding periods allows private equity managers time to implement strategic initiatives and drive corporate change.

Global trends drive infrastructure

Several long-term structural trends support infrastructure investment in the years and decades ahead, in our view.

Diversifying your diversifiers

Recent volatility has shown the importance of not only diversification through private markets, but also within private market portfolios.

Accessing private markets

Private markets can offer potential opportunities to the changes reshaping our world: the mega forces. We believe these mega forces – digital disruption and AI, the low-carbon transition, demographic divergence, the future of finance and geopolitical fragmentation – offer major investment opportunities. We see private markets as uniquely positioned to benefit from the shifts that are already under way.

As more companies stay private for longer, private markets are taking a more prominent place in the broader economy – they can provide more flexible and faster financing for companies that might shy away from public markets amid tougher macro conditions.

Private markets are more than a single investment option. In fact, they span sectors, geographies, investment styles, and risk appetites. The key to a successful portfolio is recognising these differences and choosing the right blend for an investor's needs.

Historically, private markets have principally been used by institutional investors. But in recent years, some regulatory innovation has helped make the asset class accessible to a wider range of individual investors. This is the case, for example, with the European Long-Term Investment Funds, introduced in 2015, which allows for scalable and regulated pan-European distribution of private markets investments across different investor types.

"We are entering the golden era for Private Markets – we see the biggest opportunities in the real economy as investment flows into infrastructure, energy systems and technology – and the people driving them."

Fabio Osta, Head of the Alternatives Specialists Team in EMEA Wealth at BlackRock

Private equity can offer enhanced returns

Private markets represent a large and growing opportunity that is hard to find in public markets due to the decreasing number of listed companies – in fact 86% of global companies are now private.[1]

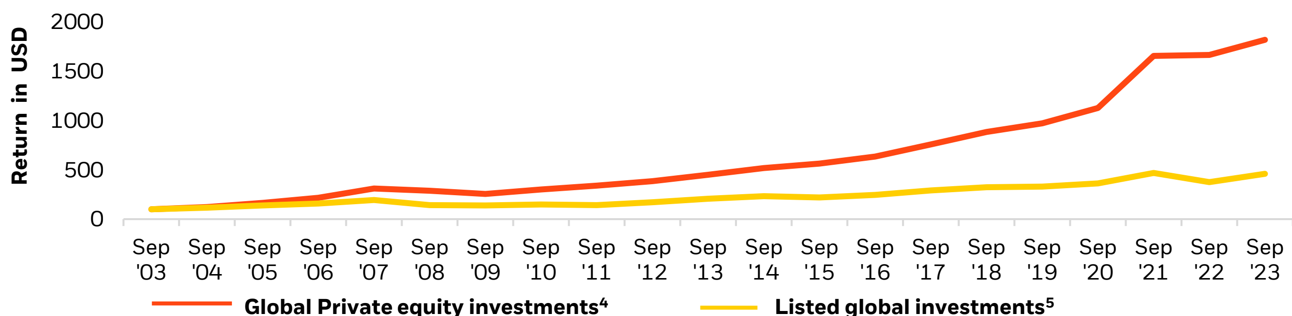
Private equity managers focus on long-term value creation through active and entrepreneurial involvement with portfolio companies. The longer holding period allows private equity managers time to implement strategic initiatives and to drive corporate change. This expanded toolkit for seeking attractive returns has historically led private equity to perform better than listed companies.

In the current environment, higher interest rates are driving cash-strapped companies to seek more equity financing, while low transaction volumes are creating attractive situations for buyers in the secondary market. Indeed, the last two years have resulted in well-below-average exit deal volume – aggregate exit volume in 2022 and 2021 of US$956 billion is less than 65% of the prior two-year average.[2] Most recently, in the first half of 2024, the markets have already registered an uptick, with exit activity on the rise and the large side of the market resuming transacting at a regular pace.

Strategic and financial buyers are still the favoured exit strategies, but the public market has also shown signs of a reopening, with larger IPOs coming back into the picture. This gives us confidence that deal activity will accelerate in the near-term and produce attractive returns for private equity buyers with access to capital.

It also creates a growing need for secondaries, as this shortage of exit opportunities has left an estimated 75% of private portfolios net-cash-flow negative.[3] As a result, limited partners are turning to the secondaries market for liquidity and to meet distribution requirements. In the secondaries market, we're seeing a continued oversupply of opportunities driving further discounts. Specifically, we see attractive valuations in the growing mid-sized secondaries market, which includes transactions that fall under the radar of larger managers, or are too big for some of the smaller pools of capital to invest in. As large companies navigate economic uncertainty and evaluate strategic needs, we also expect an increase in corporate carve-out activity. These deals can be opportunities to acquire non-core divisions with proven business models and untapped value-creation potential.

Figure 1: Private equity investments vs listed global investments



Annual Performance (%)

Date	09/18 - 09/19	09/19 - 09/20	09/20 - 09/21	09/21 - 09/22	09/22 - 09/23
Private Equity Investments	99.9%	16.0%	46.8%	0.6%	9.3%
Listed Global Investments	1.8%	10.4%	28.8%	-19.6%	22.0%

The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Index returns are for illustrative purposes only. Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. All $ figures expressed in USD.

1. Capital IQ, BlackRock as of 31 March 2023. Represents the number of global companies with annual revenues greater than $100 million. 2. Deallogic, data as of 31 October 2023. 3. PJT Partners - Secondary Investor Roadmap Series,31 July 2023. 4. Burgiss, as of 30 September 2023. Private Equity Investments are represented by the Burgiss Private Equity Index (Buyouts). Private equity buyout funds (investing in established companies) only (Number of funds: 1,976).5. Bloomberg, as of 30 September 2023. The MSCI World Index captures large and mid-cap representation across 23 developed markets countries.

Global trends drive infrastructure

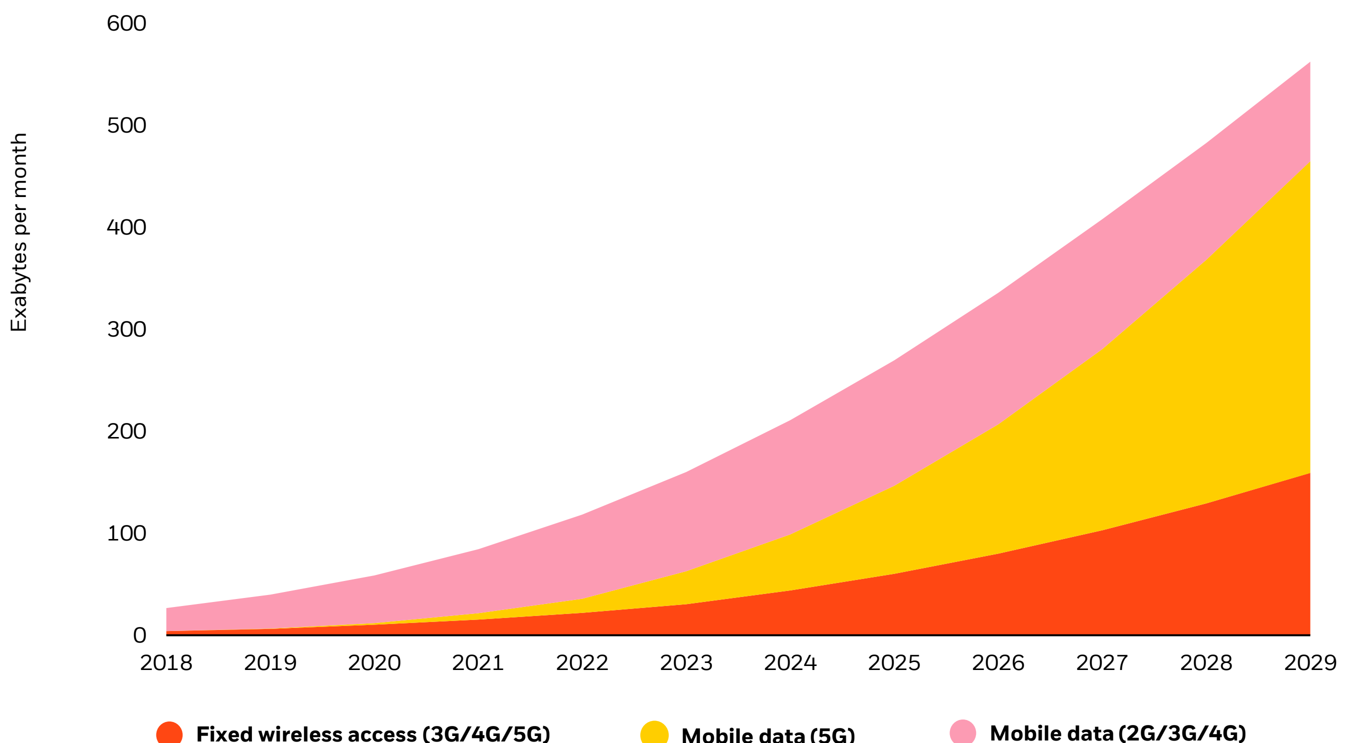
The current regime of increased volatility in stock and bond markets has revealed the inherent strengths of many infrastructure investments. Being essential to the economy and our daily lives, infrastructure offers cashflows that are less tied to economic cycles than other asset classes, resulting in resilient income and capital appreciation. Infrastructure assets often have long-term, inflation-linked contracts that can span decades – a significant advantage in a volatile environment.

While infrastructure has been resilient over the past year, the bigger story may be yet to come. Long-term structural trends support infrastructure investment in the years and decades ahead, in our view.

The global transition to a low-carbon economy requires a reconfigured energy system and investment across all sectors. Energy investment is projected to increase from US$2.2 trillion annually to US$3.5 trillion by the end of this decade and US$4.5 trillion by the 2040s.[6]
Digital infrastructure is expanding around the globe, increasing demand for fiber broadband, cell towers and data centers. Take fiber broadband – about 70% of U.S. household broadband connections are expected to be fiber by 2026 – up from 43% in 2022.[7] But the cost of building and installing those networks is roughly US$27,000 per mile,[8] an expensive outlay for a single entity to finance.

At the same time, the COVID-19 pandemic exposed the fragility and complexity of global supply chains.

Figure 2: Global data use is expected to keep climbing



There is no guarantee that they will be achieved.
Source: Ericsson, 2023. Estimates are based on assumptions.

6. BlackRock Investment Institute and Aladdin Sustainability Analytics, with IEA data, June 2023.
7. BlackRock and Arthur D. Little, 31 December 2022.
8. U.S. Department of Transportation, from "Raising the Minimum Fixed Broadband Speed Benchmark," Congressional Research Service, 12 July 2021.

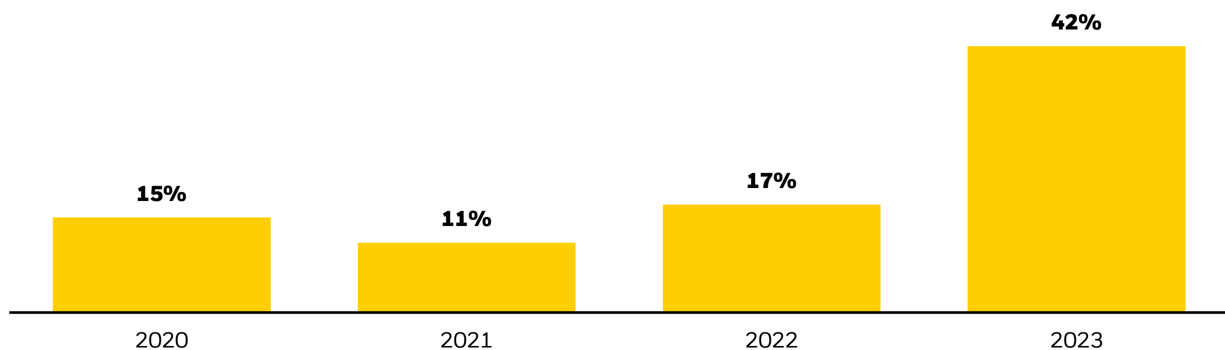
Rising geopolitical tensions are also adding to the pressure for countries to bring supply networks closer to home. Many companies are seeking to reduce their dependence on distant producers, bringing supply chains closer to their end consumers. Continued trends toward onshoring, nearshoring and friend-shoring are driving fresh investment in logistics infrastructure such as highways, ports and railways to new logistics hubs – the global shift toward regionalisation requires a range of traditional and modern infrastructure projects.

Traditional funding sources for infrastructure projects, such as national governments, cannot meet the need alone. National debt levels have tripled since the mid-1970s,[9] which is spurring public-private partnerships.

The asset class has a host of tailwinds, but managers cannot be complacent. The cheap financing that used to bolster returns is gone, forcing managers to use additional levers to create value and be active owners. They also need to be more selective. We expect greater dispersion in manager returns ahead. The macro backdrop has also made for a slower year of fundraising. In the secondaries market, we're seeing discounts for the first time. For those with capital to spend, there is an exciting window of potential opportunity to buy quality assets at lower entry points with attractive structures.

We believe that the infrastructure asset class, currently valued at US$1 trillion, is poised to become one of the fastest-growing segments within private markets.[10]

Figure 3: A growing number of global companies say they are nearshoring production



Source: McKinsey; Chart: Axios Visuals, annual surveys between 60 and 113 supply chain leaders; 2020 to 2023.

9. International Monetary Fund, "Global Debt Is Returning to its Rising Trend," 13 September 2023.
10. BlackRock, "Tracking the low-carbon transition," 30 July 2023.

Diversifying your diversifiers

Private markets can be a valuable tool to enhance the risk/return profile of portfolios. But they're not a single investment. Whether an investor is looking for income generation or capital growth, the private assets offer many options across sectors, geographies, investment styles, and risk appetites.

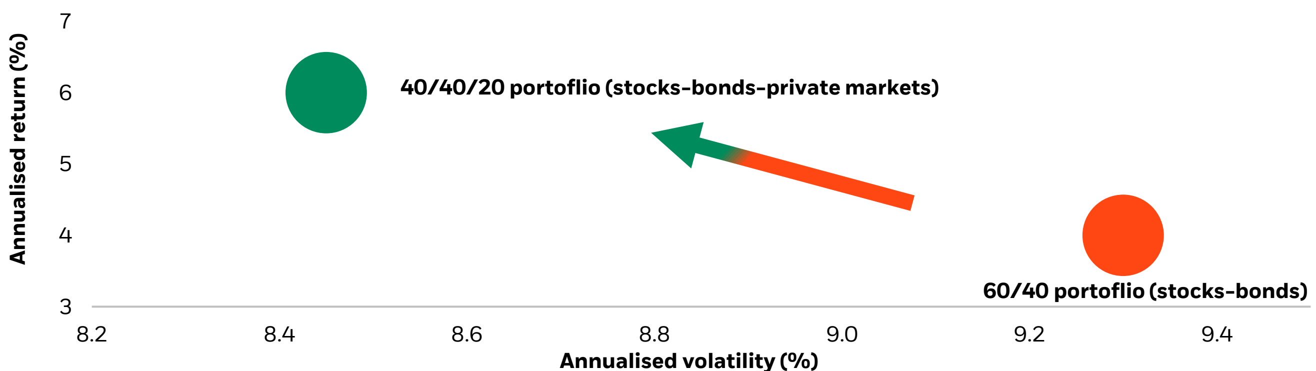
Recent volatility in public markets has further highlighted the importance of not only diversification through private markets, but also within private market portfolios. To make the most of this diversity, it's important to take a flexible and holistic approach to private markets, where portfolios can be opportunistic and capitalise on investments in areas less affected by macro headwinds and where deal flow is readily available.

In our view, risk should be considered at the total portfolio level, which includes considering implications for potential allocations and scenario-based stress-testing of the whole portfolio.

Funding for private markets allocations can come from either or both public equities and fixed income. In recent analysis published by BlackRock, The Role of Private Markets in the 'Traditional' 60/40 Portfolio (April 2024) we looked at how a 40/40/20 (stocks-bonds-private markets) portfolio would impact risk-return outcomes. We found that a 20% allocation to diversified private markets funded from global equities would increase the portfolio annual return from 4.0% to 6.0%, with a decrease in risk from 9.3% to 8.5% (see Figure 4). This impact of potentially diversifying sources of portfolio return and risk, while also delivering greater capital growth or income leads us to believe private markets may play an increasingly fundamental role in portfolios.

The current regime and heightened market volatility will continue to create dislocations and investment opportunities, in our view. Therefore, investors should view the regime as an opportunity to rebalance their portfolios.

Figure 4: Risk-return outcome for a 60/40 (stocks-bonds) portfolio versus a 40/40/20 (stocks-bonds-private markets) portfolio



60/40: refers to 60% allocated to Global Equity Proxy: MSCI All country World Index; 40% allocated in Global Fixed Income Proxy: Barclays Global Aggregate Index hedged.; Please refer to appendix for CMA details.

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Source: BlackRock, as of 30 April 2024. CMA data as of 29 December 2023. Currency EUR, time period 10 years. Return assumptions are total nominal returns. Asset return expectations are net of assumed fees. Fees and alpha are estimates for illustrative purposes only and do not represent any actual fund performance. These portfolios represent a sample of just four of the various possible solutions on the efficiency frontier. BlackRock has not considered the specific needs of the client and is not making any recommendation of any particular option. You should consider the most appropriate allocation for your needs.

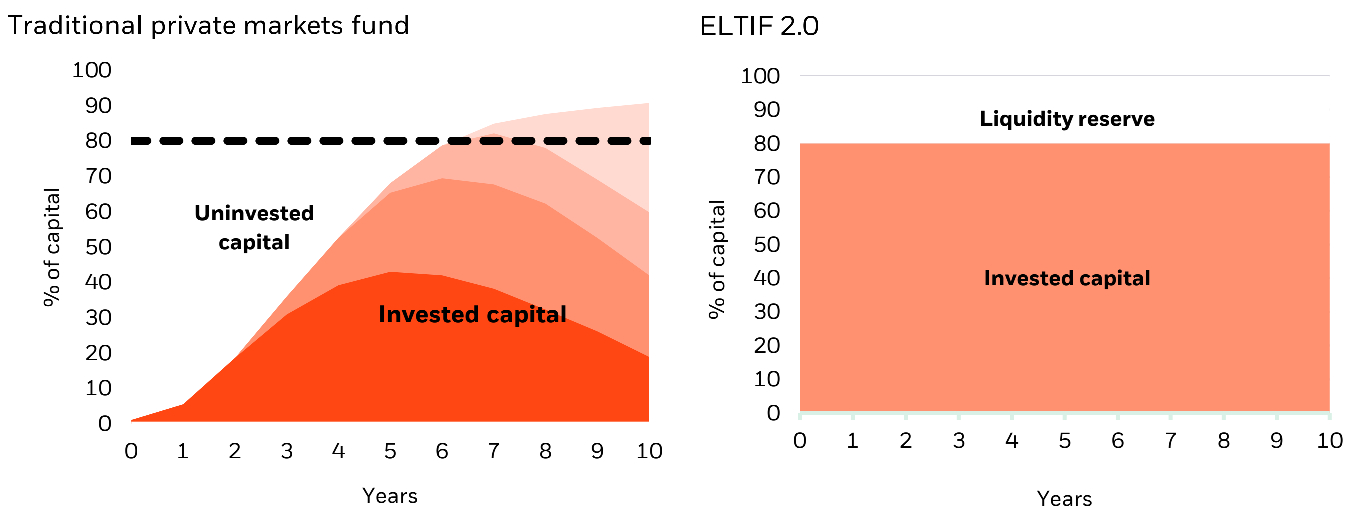
European Long-Term Investment Funds (ELTIFs) 2.0

In the more than eight years since its introduction to the European private markets landscape, the ELTIF vehicle has demonstrated its value and versatility to investors, and we expect rapid growth in the coming years. The ELTIF market is estimated to have reached EUR 13.6bn by end of 2023,[11] and the Alternative Investment Management Association estimates in flows of around EUR 100bn in the next few years.[12]

This development coincides with European investors seeking access to the benefits of private markets and wealth managers that are looking for scalable and efficient methods to deliver the asset class to their clients. While there is more than one way to meet this growing demand, the ELTIF is quickly becoming the vehicle of choice in Europe.

In addition, the EU has recently approved changes to make the ELTIF vehicle even more attractive. We believe those changes will significantly broaden the commercial use case for ELTIFs and accelerate the adoption of private markets across the European wealth market.

Figure 5: Invested capital in a traditional fund vs. ELTIF 2.0



For illustrative purposes only.

ELTIF 2.0: What's new

Designed to overcome some of the key operational and structural barriers that hindered a broader adoption of private markets in recent years, the vehicle offers:

Improving access

Introduces an evergreen, open-ended ("semi-liquid") structure, which offers liquidity at periodic intervals removing long-term lock up periods and introducing operational features which meet retail investor needs.

Harmonising suitability

Simplifies the distribution process as the ELTIF suitability check is now fully aligned with MiFID II suitability (Markets in Financial Instruments Directive).

Broadening the investable universe

Expands the investment opportunity set available to managers, allowing for globally diversified investment strategies in an ELTIF wrapper.

11. Scope, Solid growth in ELTIF market; new regulation to drive further expansion, 15 May 2024.
12. Alternative Investment Management Association (AIMA), ELTIF 2.0: Reforms set to drive significant growth in European private markets, 19 June 2023.

Unlocking access

Traditional private funds have a defined life span and managed liquidity window. In this type of structure, fundraising occurs when a new fund is launched, with limited to no ability to withdraw as that capital is invested. Institutional investors will typically ensure they meet their target allocation to private markets by running sophisticated commitment strategies across multiple funds and vintages. This complex approach is not possible for most wealth investors. But evergreen structures offer material benefits by ensuring they maintain a constant allocation to the asset class.

The difference in exposure to private markets via a mature evergreen fund with a well-diversified underlying portfolio versus building the traditional flywheel by constructing a program through multiple generations of traditional private funds and the resulting net asset value build-up is illustrated in Figure 5.

Once an evergreen portfolio has been ramped up, one can nearly instantly achieve the desired allocation. By contrast, in a program of traditional private fund commitments it takes several years to build up to that target allocation or NAV. Also, note the annual commitment amount can vary considerably, resulting in concentration risks to individual vintage years.

Why BlackRock for ELTIFs

BlackRock was one of the first movers to offer ELTIFs to retail and institutional investors in Europe, successfully launching several ELTIFs and raising $1.4bn as of June this year across private equity and private infrastructure.[13]

We plan to deliver world-class, institutional-quality investments to our distribution partners alongside outstanding client experience across legal, operational and educational matters.

Building on our market-leading position, we intend to deepen and broaden our ELTIF platform using the opportunities created by ELTIF 2.0 regulation, and launch a suite of open-ended, evergreen strategies across a range of private assets.

If you are interested in learning more on how we can help you, please reach out to your BlackRock Relationship Manager or contact us to discuss your goals and needs in greater detail.

13. BlackRock as of 1 June 2024.

Appendix

BlackRock Capital Market Assumptions Q4 2023 (10 year-period, EUR)

Asset Class	Index	Geometric Return	Volatility	Dispersion (%)
European Equity	MSCI Europe Gross TR Index	7.20%	15.30%	6.60%
EM Equity	MSCI Emerging Markets Index	6.70%	18.60%	7.00%
World Equity	MSCI World Gross TR Index	4.40%	15.50%	5.70%
World Small Cap	MSCI World Small Cap	4.10%	18.10%	7.40%
US Equity	MSCI Developed - US Gross TR Index	3.10%	17.00%	6.50%
Euro IG	BBG Barc Euro Aggregate Corporate Index	2.50%	4.20%	1.90%
Euro Gov	BBG Barc Euro Treasury 1-15 Year Index	2.00%	3.80%	2.00%
US IG	BBG Barc U.S. Credit Index Hedged	1.80%	6.50%	2.50%
US Gov	BBG Barc US Treasury Bond 10yr Term Index Hedged	1.30%	7.00%	3.10%
Global IG	BBG Barc Global Aggregate Credit Index Hedged	2.40%	5.30%	1.90%
Global HY	BBG Barc Global High Yield Index Hedged	3.60%	8.80%	3.50%
USD EM	CMA - Emerging bonds (USD denominated) hedged Hedged	3.20%	9.20%	5.00%
Infrastructure	BlackRock CMA Global Infrastructure Proxy	12.10%	20.10%	17.20%
Hedge Funds	CMA - Hedge funds (global fund weighted) hedged	3.80%	6.90%	7.80%
Private Credit	BlackRock CMA - Direct lending proxy	8.40%	15.90%	7.10%
Global PE	BlackRock CMA Private Equity - Buyout Global proxy	11.50%	27.00%	26.10%
Global Core RE	BlackRock CMA - Global Core Real Estate proxy	0.40%	12.10%	6.60%

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Methodology

Interest Rates: Our model provides a way to chart the yield curve at multiple time horizons in the future. We base this on our estimates of: (1) the short rate and (2) model implied term premia. We base our estimates of short rates on market data in the near term and on macro-informed data in the long term. We assume investors’ views about long run inflation and real growth, coupled with changing preferences as to savings and risk aversion, will ultimately determine their expectations for short rates (the “long run short rate”). We use an affine term structure model -a type of model that assumes bond yields as a linear function of a small set of parameters (Piazzesi, 2010) –to compute model-implied term premia. In our implementation, we represent the yield curve using the first five principal components of yield, as laid out by Adrian et al. (2013). We then blend the model implied term premia from the affine term structure model with market implied term premia, with the relative weights dependent on the relevant time horizon.

Equities: Expectations of cash flows and discount rates can help explain the variability in equity returns as shown by Campbell (1990). We have used this insight to develop a discounted cash flow (DCF) model, with a few key innovative features. Most academic research focuses on the question of whether stock returns are predictable at all. We are concerned with making the best estimates that we can. We make two additional contributions. First, the baseline DCF model estimates earnings by leveraging analyst earnings estimates in the near term as discussed by Li et al (2013) to derive the implied cost of capital. The common assumption in implied cost of capital (ICC) studies is that earnings growth implied by analyst earnings estimates in the near term should trend towards GDP growth in the long term. This can introduce an unintended assumption of continued expansion of profit margins. We have introduced a modification to account for late economic cycle dynamics. We allow for corporate profit margins to revert to trend (the median over a rolling 10-year history) as margins typically peak late-cycle. The standard ICC approach typically tests for equity returns using linear regression tests. For our DCF model, we take the desired time horizon as an input (number of years) and we estimate the appropriate discount rate for the specific time horizon using our aggregate implied cost of capital. This way, we account for both key sources of variability in equity returns, namely changes in cash flows and changes in the discount rate.

Methodology

Credit: Our model for credit asset (excess) returns is anchored on two key elements: 1) our estimate of credit spread at a given horizon and 2) our estimated loss due to defaults and downgrades over the horizon. The first component is projected in a consistent manner with our view of real GDP growth and the link between credit spreads and equity volatility. Our approach helps explain the behaviour of credit spreads using a limited number of predictive variables. Yet, as validated by tests against more complex methods, it retains the ability to help explain a high proportion of the variance in credit spreads. The second component is estimated based on our outlook for spreads, the duration of the asset and an assumed transition matrix which captures migrations and defaults across multiple credit cycles. We currently base our transition matrix on Moody's long-run transition data. We aim to further develop our model by directly modelling transitions based on macroeconomic conditions in order to better capture cycle dynamics and the respective variation in losses due to credit events. In addition to making our estimates of credit spreads consistent with our macroeconomic views, our new credit (excess) return model allows greater flexibility of calibrating our expected returns to different credit rating compositions which may prevail over the entire time horizon.

Uncertainty and optimisation: Expected returns and asset price volatility are difficult to predict. We believe any technique that builds portfolios should incorporate this inherent uncertainty (Ceria et al. 2006). We consider both long-and short-term drivers of return. In the long run, we expect a relatively small number of macroeconomic drivers —economic growth, rates, inflation, credit and currencies —to determine an asset's returns. In the short-run, other factors can overpower the structural drivers causing wider fluctuations from an asset's fair value. Valuations can be helpful in estimating short-term returns. We combine contributions from the long-and short-term return drivers to produce a final set of return expectations with a range of uncertainty around each.

The next step is to use this set of return expectations in an optimisation engine that seeks out the best return without breaching an investors' risk limit. Mean variance optimisation would produce a portfolio that maximises expected return under one base scenario with a given level of risk. In contrast, we look to build a "least-worst" portfolio –one that maximises returns for an investors' target risk levels across the worst outcomes, say for the bottom 50% of the distribution, from a set of stochastically generated scenarios (cf. Tütüncü et al. 2004 and Garlappi et al. 2006). This helps ensure the portfolio is not overly reliant on just the median return. This process seeks to produce a portfolio that is robust to small changes in the central return estimates (Scherer, 2006).

Stochastic engine: We use Monte Carlo simulation to create random distributions informed by historical return distributions and centred on our expected returns. The engine simulates thousands of return pathways for each asset, representing the range of possible outcomes over a five-to 20-year time horizon. We leverage BlackRock's risk models to help ensure that assets generate similar returns, to the extent that they have common drivers . The range of scenarios incorporate our work on incorporating uncertainty in return expectations. We use an extension of the Black-Litterman model (1990) –a well-known model for portfolio allocation that combines equilibrium returns and medium-term views in a single-period setting. Our model uses a Kalman filter (1960) –an algorithm that extracts insights about return paths by bringing together a number of uncertain inputs -to extend Black-Litterman into a multi-period setting. This allows us to capture the variation of expected returns over time under various scenarios —from economy-related to market sentiment driven. A large part of these variations is not predictable. Constructing portfolios that are robust to, or can exploit, these variations is a major challenge for investors. The ability to calibrate the engine with asset class views with uncertainty at arbitrary time horizons, and to evolve this uncertainty stochastically, drives the dispersion of return outcomes. Highlighting the uncertainty that investors face when building portfolios helps ensure ostensibly precise return expectations do not lead investors to concentrated portfolios.

Simulated return paths support a broader range of applications, such as asset-liability modelling. We believe stochastically generated return scenarios enable investors to move with ease beyond mean-variance and optimise portfolios against their individual needs. Investors can place more emphasis on the tails of the distribution or focus on the path of returns rather than just the total return. They can incorporate flows in or out of the portfolio over the course of the investor's time horizon or place more emphasis on scenarios that are challenging for the investor's business beyond their portfolio. Investors with complex asset-liability matching requirements, such as insurers, typically rely on stochastic simulations of returns to assess and construct portfolios

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