Pallas Perspective

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Historical Return and Volatility Enhancement May Make Private Investment an Adjunct for Traditional Portfolios

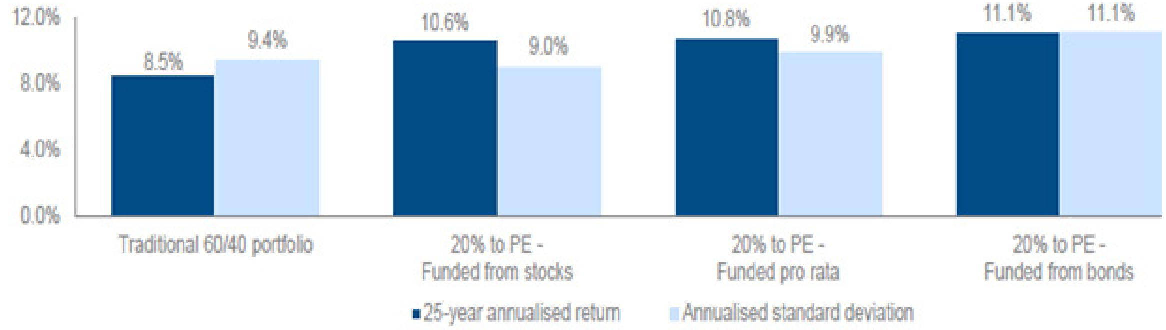
In managing an investment portfolio different types of assets can be utilized that will result in different return and volatility outcomes. A popular mix has been the 60/40 portfolio which is constructed 60% from a broad range of stocks and 40% from a pool of bonds. The 60/40 model has yielded stable returns during most periods in U.S. financial history with stocks providing the long-term engine and bonds protecting on the downside during periods of economic contraction, a symbiotic relationship that generated attractive risk-adjusted returns. However, during periods of rapidly rising inflation, such as occurred in 2022 and in the early 1980s, the ability of bonds, particularly those with longer duration, to act as a counterweight to declining stocks can be neutralized due to rising interest rates. With a longer-term horizon, these jolts to public markets have been overcome. However, investors with longer-term horizons to ride out increasing public market volatility have options in the form of private market investments that have historically complemented and enhanced traditional public market allocation models.

Private markets can be broadly divided into equity and income-oriented buckets. The private equity bucket tends to invest in companies that are like their public market counterparts with profitable companies forming the traditional private equity investment base, and high-potential but unprofitable companies populating the venture capital base. On the private debt side, private loans, secured and unsecured, are common investment options, while real estate and infrastructure are somewhat hybrid options with equity and debt characteristics. While many private investment options exist, in the context of this review the analysis will focus on adding private equity to a traditional portfolio.

The following analysis compares the return and volatility impact on investment returns over a 25-year period using the broad indices for public equities, public bonds, and private equity:

Private Equity Allocation Impact on Returns and Volatility

(25 Years between 1994 – 2019)



Source:eVestment, for the period June 1994 - June 2019. For illustrative purposes only. Data through 2019 provides the most sufficiently seasoned private equity returns. Based on S&P 500 monthly returns, Bloomberg Aggregate Bond Index Monthly returns and Cambridge US Pe Index quarterly returns.

Past performance is not an indicator of future results.

The results of the analysis show that adding private equity in place of the public equity component of a 60/40 portfolio potentially enhances return and lowers volatility and when added in place of the bond component may add further to return while remaining well below the average 15% volatility measure of public equites on their own. The findings should not be surprising when looking at private equity returns and volatility in isolation as the category has consistently returned over 300 basis point of excess return versus public equities on a long-term rolling basis with less standard deviation (volatility) from year-to-year.

The historical data makes a compelling case for qualified investors to consider the addition of private equity, particularly as an adjunct or replacement to public equity, but key considerations include liquidity risk, access to high quality private equity investments, diversification, high minimum investment commitments, potential for ongoing investment calls, and complication of taxes. These barriers have traditionally been barriers outside of institutional portfolios. However, many of these barriers are being addressed resulting in private equity becoming a more viable option for individual investor accounts.

Pallas Capital Advisors believes private investments both on the equity and fixed income side can be an appropriate addition for accounts when they are consistent with the client's resources and long-term goals. While historic data has shown the benefits to long term returns and volatility with the addition of private markets to traditional public portfolios, future performance cannot be assured and limited or lack of liquidity or ability to exit the investment, are important considerations.