PARK AVENUE CAPITAL | NORTHWESTERN MUTUAL PRIVATE CLIENT GROUP

PAC INSIGHTS

Welcome to November 2024 PAC Insights – our exclusive market commentary. Before you dive into this exhilarating edition where we discuss private investments, can we please ask one favor? Follow us on LinkedIn! Click here to follow Park Avenue Capital on LinkedIn.

We also distribute our monthly commentary on social along with other great pieces of content. We look forward to connecting with you. And without further ado, this month's topic:

Private Investments – Deliberate Differentiation

ChatGPT’s rendering of Park Avenue Capital Advisors standing on the rock of financial planning and investment implementation principles while the masses follow the mythical allure of private returns.

“Serious investors consider carefully the certain results of low-cost passive strategies before pursuing the uncertain returns from high-cost active management activities.”

– David Swenson

QUICK HITS

- **The Role of Private Enterprise.** We are huge fans of private enterprise and its contribution to the economy. All public companies start as private ones.
- **Private Markets and Long-term Investing**. To create differentiated product offerings that attract retail investment, product sponsors have created a vast market of private investing as a complement to traditional equity investing. We think the risks and challenges are unsuitable for long-term planning allocations, so we are differentiating ourselves from the trend. What happens to investment returns when everyone chases the same things?
- **Marketing vs. Reality**. Sophisticated marketing often exaggerates the benefits of private investments and obscures the true risks, costs, and limitations of the private investment experience. Not every private business needs to be accounted for in market opportunity for most investors.
- **Implementation Tenets**. We remain committed to our core investment implementation tenets of control, simplicity, and transparency and avoiding unnecessary risks posed by private investments.

Evaluating Investment Opportunities

At PAC, we are regularly pitched investment opportunities, including both traditional and private investment sponsors. Recently, we reviewed an investment focused on the consumer artificial intelligence (AI) market, promoting innovations in smart home technology and AI-driven devices. This opportunity also has investments in tools for automation and AI applications on smart phones. Sounds intriguing, right?

Well, you already own it, and while it's not a private investment, it invests like one. Due to our broad exposure to the U.S. stock market, **many clients are already invested in Apple, which holds a commanding position in future AI development.**

According to media sources, as of October 2024, Apple has acquired more than 100 companies, maybe more. Apple CEO Tim Cook in a 2019 interview said Apple acquires a company every two to three weeks on average, often with no announcement. A little different from its large Tech peers, Apple's acquisitions tend to be smaller in size and in technology areas where Apple can incorporate the products, talent, or both. Some of Apple's larger acquisitions include Beats Electronics, Shazam, PrimeSense, Darwin AI.

Said differently, Apple, and its peers, are among the best dynamic private equity and venture funds in the world. As an investor, you get access to these premier buyout companies with no intermediary fees, costs or liquidity constraints.

In our opinion, this example highlights a fundamental point: **many private investment opportunities marketed as exclusive or innovative are often just hyped-up versions of opportunities available in the public stock markets.**

Don't mistake our view, we are huge fans of private investments. We have the most innovative and dynamic economy the world has ever seen, and private investments play a vital role. We agree that the opportunity in private investments continues to grow. Like Pandora's Box, however, alternatives are full of promise on the outside but unleash a host of complications once opened.

Some clients have unique needs and preferences, for example finding tax solutions or dedicated preference for certain investments, and private investment options may be a fit. Other clients own outside private investments. Many have achieved wealth through entrepreneurship and liquidity events from private businesses. Others still are connected to unique private business opportunities. We are as excited about these opportunities as anyone. The question before us, however, is whether they should play a role in long-term planning asset allocation. Here we think most private investment options fall well short of our objectives.

Why We Don't Embrace Private Investments

In our experience, for most clients, private investments detract from the long-term plan. Private investments come with a host of challenges that can undermine their appeal:

1. **Higher Costs:** Management fees, operational fees, and performance-based incentives significantly reduce the net returns on private investments. These costs, along with tax implications, create an exceptionally high hurdle rate for these investments to outperform traditional, low-cost ETFs or index funds over the long term.
2. **Illiquidity:** Many private investments lock up capital for years, making them unsuitable for clients who may need access to their funds. In times of financial stress, liquidity is a crucial factor, and private investments rarely provide the flexibility required in such situations.
3. **Lack of Transparency:** Private investments are often opaque, making it challenging to understand the true value of the assets within the fund. This lack of transparency introduces unnecessary risk, especially when compared to the clear, regulated nature of public market investments.
4. **Higher Risk:** Many private investments use significant leverage to enhance returns.

Investments should be straightforward, easy to understand, and aligned with our clients' financial plan. The more complex an investment is, the more likely it is to introduce risk, confusion, and unnecessary costs.

Distinguishing Marketing Hype from Reality

Individual investors and advisors alike are the targets of highly sophisticated marketing campaigns. Retail adoption of private assets presents a multi-billion fee opportunity for large investment managers. We are told about exciting breakthroughs in solving the private markets' "allocation gap," asset allocation "underweights" or investor "access" needs, historically accessible only to institutional investors.

Private investment sponsors seek to get the public interested in their investments. For advisors, they go farther, they want to convince us to choose their products in asset allocation decisions.

Why? Leverage.

Advisors select on behalf of millions of clients. Identifying marketing techniques can help separate reality from hype. Here are a few actual examples:

- **Marketing**: The growing role of private markets in financing the economy has increased fundraising for the asset class, which has now surpassed global public markets equity issuance each year since 2016.
- **Reality**: Public equities have massively outperformed private market since 2016.

- **Marketing**: The number of IPOs globally decreased significantly since 1990.
- **Reality**: Starting with 1990 includes the technology bubble IPO issuance of the late 1990s. Of course, IPOs are lower. There is no evidence that a lower number of IPOs negatively impacts stock returns.

- **Marketing**: The role of private markets in the real economy is significant.
- **Reality**: No question about it! Most people accumulate their wealth through work, entrepreneurship, or being employed by small companies or larger public companies. The stock markets are the extension of the economy that provides the best investment opportunities in the world with the safeguards of rule of law, transparency, disclosure, and fair dealing. Public companies operate in the real economy just as much as their non-public counterparts. The argument that every mom-and-pop enterprise needs to be accounted for as an investment opportunity among retail investors is ludicrous.

- **Marketing**: The growth of private markets shows no signs of slowing down.
- **Reality**: Fantastic! This means the U.S. economy is growing as it should. It also probably means that the economy is stronger than most other parts of the world. As our economy continues to grow, smaller companies will join the ranks of transparency and disclosure through public filings, and many more will be absorbed by highly liquid and innovating companies seeking to expand or grow into new markets. No extra fees required to benefit from this growth, just a willingness to take a long-term view and hold on to your equity investments through good times and bad. Imagine the possibilities of being a public stock market investor!

Private investment sponsors, the firms that create limited partnerships, have their own businesses to grow. Some of these firms are privately held, while many are themselves large publicly traded companies. These companies have obligations to shareholders to expand markets and grow profits. As investors in these companies through core U.S. equity ETFs, we are huge fans.

But that doesn’t mean we need to participate in their products as stewards of our clients’ assets. In a free market rife with innovation, we get to choose the best path for our clients. ETFs are every bit as innovative and disruptive as the alure of private markets, and we utilize the ETF innovations to improve long-term outcomes.

Risks of Private Investments

Individuals rarely benefit from the best returns offered by private partnerships. The most favorable returns go to the general partners who collect the fees and receive preferential treatment, and large institutions who leverage their scale for advantageous deals. Indeed, most of the highly sought-after private investments are fully subscribed with little or no need to sell through retail channels.

"You could also advise her to buy shares of SpaceX, if you want, but you probably can’t get her any SpaceX shares. (You could advise her to put her money into Citadel’s hedge fund, or Renaissance Technologies’ for that matter, but you probably can’t get her into those funds either.) There are private investments that are, as it were, mass marketed to accredited investors, and there are others that are not. There is some reason to think that the hottest startups are not looking to raise every last dollar from dentists, while the least hot startups might be.”

- Matt Levine, Bloomberg Columnist

As the market environment for private equity has become more challenging marked by higher rates, unimaginable amounts of committed dry powder, and fewer exit opportunities, media outlets have reported on some of the ways private equity funds are being creative with lending and capital calls to mitigate underperformance or boost IRR (Internal Rate of Return). These strategies may include subscription lines of credit, NAV loans, and the use of continuation funds. Of course, not all funds engage in these strategies, but enough do to warrant broad skepticism and a closer look at each opportunity.

Most private investment performance indexes rely on self-reporting. This may result in highly skewed results from survivors with good enough performance to self-report. We have some insight into private equity performance through the public markets. Over the last 5 years, PSP (Invesco Globally listed Private Equity ETF) has underperformed the S&P 500 by nearly 50% (cumulative).

Finally, perhaps the biggest risk is buyers' remorse, committing capital today only to regret it when the capital is called over the ensuing years.

Behavior

As humans, we want to believe that superior performance comes from intelligence, hard work, experience, and sound judgement. The investment media tends to promote extremes and worship the top performers. It's easy to conflate the experience of a few phenomenally successful private fund managers with the opportunity across the entire space.

But the private investment space has a much higher dispersion of outcomes than traditional active stock pickers. Unfortunately, behavioral finance has not yet discovered an effective way of distinguishing between skill and luck. The opaque nature of private investments clouds visibility into the risks the winners took to achieve their results.

Finally, what happens to investments when seemingly everyone else chases after the same thing? The history of financial markets is not kind to performance chasers.

CONCLUSION

Why We Believe Simplicity Wins

David Swenson, quoted above, is considered the founder of the "Yale model" of allocating to private investments. In his book "Pioneering Portfolio Management" he clearly states that private investing does not work at the mass market level.

> *"By pursuing safety and avoiding controversy, bureaucratic structures systematically screen out the market opportunities likely to yield superior returns… failing to address even elementary active investment management problems…Most fiduciaries pursue investment with "name brand" money managers, reducing career risk by choosing easily recognized firms blessed by an external consultant. "Safe"*

investment managers tend to be large, process-driven entities… Achieving institutional acceptability threatens the very characteristics that made the firm interesting in the first place."

Private investments are often marketed with enticing narratives—access to exclusive deals, exposure to innovative sectors, and promises of high returns. Many of these opportunities are simply dressed-up versions of publicly available investments[1], and they often come with additional layers of risk and cost. At PAC, our commitment is to provide straightforward, cost-effective solutions that align with your long-term financial goals. Private investments, despite their allure, often fail to deliver on promises.

By adhering to our disciplined investment philosophy, centered on control, simplicity, and transparency, we ensure that your portfolio remains aligned with your financial objectives. Our objective is to deliver the outcomes you need for a secure future.

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[1] We are referring to private equity investments. There are many other types of private investments that come with similar risks. For example, "private credit" is a popular offering today with promises of 9% to 13% yields in most cases. For reference, the 10-year U.S. Treasury yield is about 4.1% at the time of this writing. In other words, these investments are much riskier than public fixed income "credit" counterparts .