

Anna Marcus (00:00)

Financial advisors increasingly understand the value of private markets. Things like higher long-term return potential, potential diversification, and potential downside protection. But there's a problem. While advisors may believe in the private markets thesis, they actually struggle with implementation. And so today, we're talking about this implementation gap. Why advisors struggle to allocate to private markets and how to solve this problem with a practical, easy to understand framework.

Welcome to RPM, the StepStone Group podcast that delivers quick insights and sharp takes into the themes and trends shaping the private markets. I'm your host, Anna Marcus. Today I'm joined by Miguel Sosa, a managing director and senior investment strategist for StepStone Private Wealth Solutions, and David Robbins, a director for StepStone Private Wealth Solutions who is focused on the RIA channel. This episode follows our recent white paper. A Thousand Words or Less, a practical framework for implementing private markets into portfolios. David and Miguel, thank you very much for being here. Let's dive in.

David Robbins (01:17)

Thanks for having me, Anna.

Miguel Sosa (01:18)

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Miguel Sosa (01:19)

Thanks, Anna.

Anna Marcus (01:20)

To start, that recent paper we released on this topic describes a key challenge. Advisors understand the opportunity and see the value in private markets, but they struggle with the operational complexity of actually implementing allocations across many client accounts. Miguel, let's start with you. Two questions, actually. First, why do advisors believe in private markets but hesitate to implement them? And then two, what operational barriers are you seeing most often in your conversations?

Miguel Sosa (01:50)

Yeah, these are great questions to start with. And investors understand that public investment markets have grown more uncertain in the last couple of decades, certainly in the last year or so. And simple allocations to public equities, into public fixed income may not deliver the returns that they did several decades ago. So on the second hand, they also need to deliver value to their clients and volatility and uncertainty currently are high within public markets.

So there's several barriers. The first barrier really is more educational. They may not or they feel they may not know the asset class. There's tools to help understand private markets such as Morningstar or Interval Fund Tracker. But once they do start to learn, they may also feel overwhelmed by the number of offerings that are available. And secondly, they have to understand the different structures. There's interval funds, there's tender offer funds, there's BDCs, and there may be other variations as well that they need to educate themselves on. And secondly, once those educational barriers are overcome, there's operational barriers. How do they invest? Is it via a ticker symbol similar to mutual funds, or do they need to fill out subscription documents? How can they reallocate? So if they've decided to move forward, How are they going to rebalance their existing portfolio and where are they going to take capital from to allocate? Do they take away ~ from equities or fixed income or from underperformers in their current allocation or outperformers? And lastly is how do they monitor ongoing performance for private markets? So they certainly are conversations around structures and also around the broader landscape that they should be aware of.

Anna Marcus (03:43)

Yep, wow. So it really sounds like there's a lot of moving pieces to truly understand. And David, then switching over to you, going off of that, how big would you say is this

implementation gap in the advisor channel? Can you quantify it or maybe talk about whether the problem is more educational than infrastructure based?

David Robbins (04:04)

And I would love to be able to quantify it. It would certainly make my day-to-day job much easier. ~ Needless to say, the ~ ambitions for larger allocations are certainly higher than the actual allocations when it comes to private markets. But to your second question about how big is the gap, I would say massive.

Miguel already touched on one of the reasons being education, but the second has really been scalability. ~ And let me give you some context there. So over the years, I have sat down with advisors in 45 states and lost track of how many times advisors have said to me, I understand the value that private markets have to offer when it comes to ~ portfolio, construction, the diversification, I just don't have the resources to implement it. And we've seen change over the last several years that has prompted not only this conversation, but the paper ~ that we put out.

Anna Marcus (05:19)

Yeah, interesting. And so I want to talk more about this change. Going a little bit deeper, obviously the traditional 60-40 portfolio has been the main sort of way that has worked for decades across a wide range of investors. But as you mentioned, market dynamics are shifting. There's concentration risk in public equities. In fact, the top 10 companies now represent over 40 % of the S &P 500 market cap.

And then of course, the stock and bond diversification profile is actually weakening. So David, staying with you, can you talk to me a little bit about what's changed in public markets in the past decade or so?

David Robbins (05:59)

Certainly. Well, it's not news to many that over the past 20 years, the number of publicly traded companies has been cut in half. But specific to your question around the past

decade, what you've seen is, the composition really evolved? You mentioned, you know, the concentration of the top 10 holdings of the S &P and representing about 41 % of the market cap.

But more specifically, you've seen industry ~ focus. Now, when you look at the top 10 holdings, it's primarily technology and consumer discretionary with a few others mixed in. 10 years ago, yes, technology led that top 10, but you also had exposure to healthcare, manufacturing, and even financials.

You know, the result of that is, you have serious ~ correlation in your top 10 holdings, which for the investor, that means that everything's going to move in concert with one another.

Anna Marcus (07:10)

And that really opens the door for private equity. So Miguel, how would you say private equity actually diversifies compared with public equities?

Miguel Sosa (07:19)

Yes, private equity has historically been an excellent diversifier. And in fact, one could argue that diversification is its greatest appeal. It offers a relatively stable return profile, historically speaking, even during times of market volatility. And so there's two ways to consider diversification, correlation and volatility. Now, public equities, as David just mentioned right now, are highly correlated.

As an example, if we look at the top holdings right now within the S &P 500, and we average the correlation of each of those individual stocks to the overall S &P 500, the average correlation is 0.67. So 0.67 correlation of that concentrated exposure of top holdings. So not only are they driving returns, but they're also driving volatility.

And remember the overall volatility historically for the S &P 500 is about 15%. Contrast that to private equity, which has had historically a much lower volatility. Even for daily price vehicles, we're seeing volatility ranges in the 5 % range upwards to 10 or even 11 % for most

asset classes in private markets. The second risk metric to consider in diversification is drawdown.

So in environments of more extended market sell-offs, how do private markets hold up? Well, private markets participate in a fraction of a sell-off in public markets. So for example, in the tech sell-off of 2021 and 2022, public markets sold off about 25%, but private markets only sold off about 9%. So that's a 37 % participation rate for private markets in the magnitude of public markets. That's also known as downside capture. So the similar concept holds true in previous crises and sell-offs. We've seen downside captures, historically speaking, between 40 % and 70 % of public markets. So on the flip side, though, during expansionary cycles or bull runs, we're seeing private markets capture practically all of the gains that public markets experience. So there's about a hundred, in some cases, upwards of 110 % upside capture. So private markets offer an excellent diversification for investors' portfolios.

Anna Marcus (09:55)

Yep, that's really interesting. So thanks for walking us through that, Miguel. Let's talk at a high level about why private markets actually belong in portfolios. Obviously, there's those diversification benefits we touched on earlier, including lower correlation with public markets, the potential for stable returns, operational value creation, and of course, the list goes on. But Miguel, when advisors really think about private markets, what role should they play in a portfolio and why?

Miguel Sosa (10:25)

Great, so certainly we touched on portfolio metrics of diversification, correlation volatility, but the majority of investors seek one of three characteristics really. It's either total return or it's return via income or that portfolio stability, right? The diversification that we just talked about. And private markets play a role in all of these three characteristics. So if we look at, for example, the asset class for growth equity and venture, we see very exciting growth opportunities there. The main thesis for investment there is which companies are the most significant innovators or disruptors in their specific space. Just like the Magnificent Seven have disrupted their particular sectors, which companies will be the next Magnificent Seven? And whether it's companies that are focused on aerospace or innovation within the defense industry, cybersecurity, or even

potentially less exciting sectors such as banking or consumer discretionary, those are the innovative companies that we focus on that can potentially deliver that total return. Secondly, we have private equity buyout, which also offers that total return potential, but also with a little bit of a steadier return profile as manifested through a lower volatility profile.

And for a combination of income and diversifying characteristics, we have two asset classes, private credit and private infrastructure. So although private infrastructure invests in equity, it's among the best equity asset classes for diversification, given its low correlation to other equity asset classes, both public equity as well as private equity. Then there's a yield component and given investments in these asset classes, offer or are targeted to generate revenue, there's also that attractive component for investors. Similarly, private credit has significant cash flow, in some cases, close to 10 % yields with lower correlation to broad markets.

Anna Marcus (12:34)

so in the paper, we actually talk about this. We talk through a framework that identifies three different investor archetypes. David, switching gears for a moment over to you. Can you please explain to us those three archetypes?

David Robbins (12:48)

Poppy too. And, you know, before I do that, I want to emphasize the point you just made, which is that not every client should have the same private markets allocation, but it doesn't mean that they couldn't. You know, there's certainly clients that have similar needs, whether it be income or growth. That said, in working with advisors across the country, we found that having three starting points for the conversation, income, balanced or growth makes implementation far more scalable than reinventing the wheel with each and every client. Now, I don't think the audience wants to hear me rattling off percentage allocations to the four different aspects of private markets, but maybe some anecdotes would be helpful. So taking your traditional 60-40 and shifting closer to a 50-30-20,

50 % in public equities, 30 % in public fixed income, and then 20 in private markets, I'll share these three anecdotes with you. An income-oriented investor would likely allocate somewhere in the neighborhood of 13 % to private credit, where a growth-oriented investor may only have 3%. On the flip side, a growth-oriented investor may have a 6 % allocation to venture and growth equities, whereas an income-oriented investor would have zero. and dovetailing off the point that Miguel made around private infrastructure. My first two anecdotes highlighted the extreme differences. The most consistent allocation, regardless of the client you're speaking with, could be infrastructure, which could be anywhere from 5 % for an income-oriented client to 3 % for a growth investor.

Anna Marcus (14:48)

Really, really interesting, David. Thank you. And maybe let's just dive a little deeper on this because I do think this was sort of the meat of the paper and what our listeners and viewers might be most interested in. ~ Let's do an example. So why would you say private credit might make a natural fit for more of an income-focused investor versus, a growth-focused investor?

David Robbins (15:10)

It's a great question. you know, private credit offers several elements that you're just not getting in the public markets. know, number one, it's diversification. As we touched upon earlier, you have a far ~ greater opportunity from a diversification standpoint. You're also able to command a much more attractive income stream. So some investors that are at that point in their

Miguel Sosa (15:39)

Thank

David Robbins (15:39)

~ life

or investment goals that they're more focused on the income than they are the growth of their overall asset. They want to take advantage of the asset class that has the most attractive yield.

Anna Marcus (15:53)

Okay, great. Thank you so much. Yeah, so nearing the end of this session, let's tackle the core theme of today, implementation. I think we've made it quite clear that the investment case for private equity is strong. However, operational complexity continues to remain a challenge. Miguel.

This paper highlights evergreen structures and ticker traded vehicles as solutions because they actually simplify administration and also allow investors and advisors to scale allocations across accounts. ~ Can you talk to us a little bit about how evergreen structures are changing advisor adoption?

Miguel Sosa (16:30)

Yes, Evergreen's are offering a compelling investment case given that they simplify the investment process across the board. From the investment side, they offer in some cases daily subscriptions. They offer the ability to be immediately deployed in private markets versus waiting for capital to be called. There's transparency as well, whereas every quarter holdings are published not necessarily the case in traditional drawdown type of private market vehicles. There's low minimums and there's opportunities for liquidity in some cases every quarter. On the administrative side, the taxes are a little bit easier because they offer 1099s versus K1s in limited partnerships. And in fact, institutions which historically invested in these more complex limited partnerships and in a capital cost structure we're now starting to look at evergreens precisely because of the appeal and these advantages that are available to wealth investors and to advisors.

Anna Marcus (17:37)

Got it, yeah, thank you. And then David, what does scalable implementation actually look like in practice?

David Robbins (17:43)

So when you're thinking about it in practice, we don't expect investors that have a 0 % allocation to jump to what is often referred to as an institutional allocation in private markets, which would be 20 % or greater. That said, I would caution those advisors who aren't yet allocating to private markets is there is such a thing as going too slow. Similar to in the public markets.

If you're only allocating a small amount, one, 2%, all you're doing is adding a line item to your client's portfolio, but not actually changing the outcome. That's why in the paper that we published, we suggest starting out with a 5 to 10 % allocation, making sure the investor is comfortable with the illiquidity, and then going from there.

Anna Marcus (18:37)

Okay, that makes sense, thanks. Ending here now with one final question for you both. Miguel, I'll start with you. What is the biggest misconception advisors still have about the private markets?

Miguel Sosa (18:50)

Well, I would say, and one could argue that it is more difficult to invest in private markets than public markets. And I would counter by saying it's not necessarily more unwieldy to understand than public equities. understanding the underlying portfolio companies is conceptually similar. You do need a basic understanding of how, excuse me, how I contrast to public markets. But fundamentally, there's more similarities than differences.

And maybe because of the fact that public markets are so highly visible and they change every day, investors feel that they may have a better understanding of them relative to private markets, which don't have that level of instantaneous feedback to the news cycle. But the differences mainly arise in the mechanism of investing in private markets. So we seek to help investors understand those differences very well. And so we offer an academy, we offer educational resources on a wide variety of topics, not just investment related, but also operational topics such as what we've just discussed today.

Anna Marcus (20:01)

And then David, if an advisor could take one lesson from today's conversation, what would it be and why?

David Robbins (20:07)

You know, that's a challenging one. As I recognize our audiences at a number of different points in the journey to allocate to private markets. But if I were to leave them with just one lesson, it would be to think about their current asset allocation and the framework that was suggested in the paper relative to how much markets have evolved over the last 20 years as their asset allocation involved. And if not, maybe it's time to reconsider.

Anna Marcus (20:39)

then on that note, that wraps up today's episode for us.

And just to end, private markets are no longer just for institutions. The real challenge is implementation and how to actually implement private markets efficiently into portfolios. And that's really why we brought David and Miguel on today. So David and Miguel, thank you so much for being here.

And for more information on this topic, you can check out our recent white paper, A Thousand Words or Less, a practical framework for implementing private markets into portfolios. That 1000 Words or Less series offers quick, actionable insights into specific private markets topics. And as always, please listen to and or watch our PM wherever you get your podcasts. I'm Anna Marcus. Thank you again.