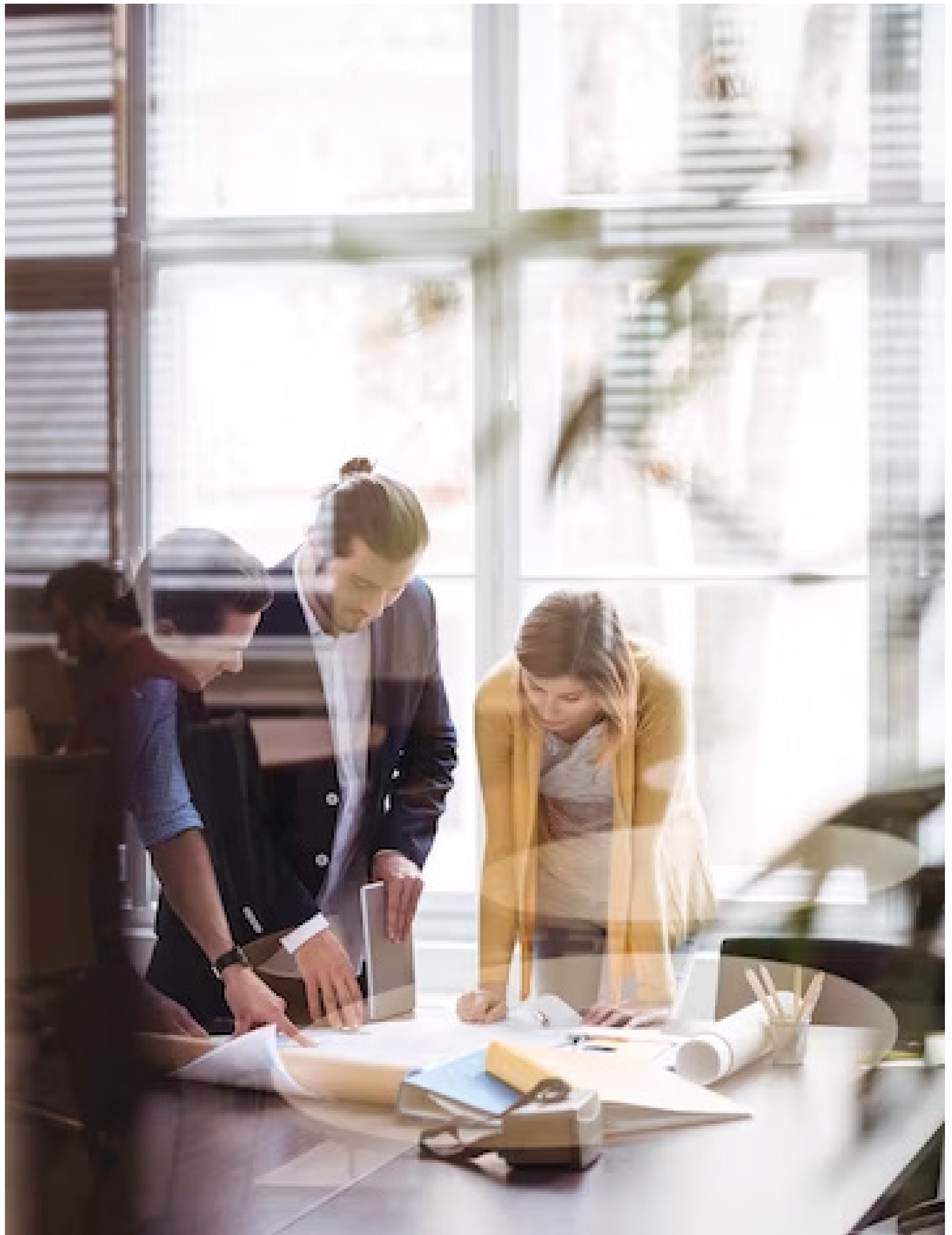
CIBC MELLON

Private Markets in a Changing Economic Regime

How Canadian asset owners are reexamining their focus

OCTOBER 2023



This article will focus on the challenges facing small to medium-sized institutions and how they are selecting and working with GPs to facilitate investments in the private market arena.

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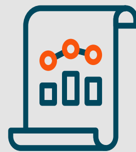
Private markets have grown vigorously in the past decade, and so has the opportunity for a broader set of investors to participate in private market alternative investment solutions. In Canada, of 1.22 million employer companies, only 2,200 are publicly listed. Evidence suggests the trend growth rate of private companies remains vigorous and that many firms are choosing to remain private for longer, fuelling greater demand for private market financing solutions to fund future growth.

The Case for Private Markets

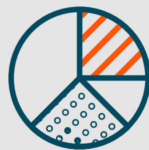
According to CIBC Asset Management's paper, the size of private equity funds is growing larger, the gap between fundraising rounds has declined, and the average fund exceeded capital raising targets by 18 per cent in 2022. Other asset classes realized solid growth as well. As a result, private markets are becoming an increasingly important source of capital for the global economy and an increasingly viable opportunity for investors.

REDUCING VOLATILITY



- A hedge against inflation; prescient given this market.

DIVERSIFICATION



- The desire for diversification among institutional investors seeking new sources of return is fuelling allocations to alternative assets. In turn, this requires a sharper focus on balancing exposure and liquidity within the overall portfolio, while managing a deluge of new data.

RETURNS

- High absolute returns.
- High risk adjusted returns over the short, medium and long term.
- Non-financial or multi-mandate purposes. For example, investing to achieve broader mandates like reinforcing local infrastructure or to meet a social finance goal.

Explore with us

We would be pleased to discuss these themes further, including exploring them in the context of our ongoing Canadian and global research efforts. Please don't hesitate to contact your relationship manager to arrange a discussion.

Alternatives were sought after for a long time in the low-rate environment, but in this rising rate environment how are you evolving your thinking/strategy around alternatives?

Higher yields have boosted the appeal of bonds, but we are still dealing with inflation uncertainty and policy uncertainty.

1. Are alternatives acting as a hedge in the rising rate environment?
2. Are different types of alternatives playing different roles within your portfolios? For example, is the strategy for hedge funds and private credit potentially different than private equity, real estate, infrastructure?
3. Are alternatives still providing an additional source of diversification and returns?

The denominator effect

When market changes result in an over allocation to private markets, how do you manage the denominator effect?

According to an article from Torys, while some LPs are experiencing the denominator effect due to diversions from perceived optimal portfolio construction, others have internal policies that require them to hold no more than certain specified thresholds in certain asset classes. Regardless of the denominator effect being a current concern for some LPs, other LPs are finding it less of a concern now than it was for them during the global financial crisis. Perhaps since then, they have developed better systems to manage potential shifts in portfolio construction.

This over-allocation to private assets is one of the reasons some LPs are considering selling some of their private market investments to decrease their private market allocation and rebalance their portfolios, as well as reassessing their capital deployment plans, potentially reducing their new capital commitments to private funds.

Investment models: To in-source or outsource?

According to CIBC Mellon's research, for asset owners with more than $750m of assets more than half of their assets are managed in-house, with respondents noting an intent to raise that in the near future.

There are reasons for this on both sides, with those in-sourcing alts management pointing to better alignment with long term strategies, better overall returns, and lower overall costs. **This is a core principle of the "Canadian model" for pension plans. For those who aren't investing tens or hundreds of billions, it can be harder to get to scale.**

Furthermore, CIBC Mellon's research suggests that not everyone who took assets in-house experienced cost savings. Some of those who went down the insourcing route either paid more for the same results, while others expended more capital and saw lower returns.

Indeed, there are many barriers. Challenges persist such as accessing data and finding the right talent.

ESG and social impact allocations: How do you manage those aspects of your investment activities?

Many asset owners also point to the potential to maximize long-term returns and to manage costs. These benefits are not necessarily the primary motivations for maintaining or augmenting in-house teams, but they are cited by 38 per cent and 36 per cent of respondents.

Another benefit of in-house management worth highlighting is the transparency around ESG factors. While only 10 per cent of respondents said ESG-related issues were a driver behind in-house approaches, respondents had apparent positions.

Governance is just as much an issue in private equity investments and infrastructure vehicles where value can be lost easily. The margin for error in private investments is not always large, so a failure can be highly consequential if it does occur, underscoring the importance of considering the risks from governance failures within private businesses.

Perhaps this is why according to our research the driver for those choosing to outsource to external managers is about confidence – in particular better risk management and the ability to leverage proven talent from external managers.

ACCORDING TO ONE CHIEF INVESTMENT OFFICER:

> "Compliance proves itself to be a difficult feat when dealing with an external team on our ESG strategy. It takes a long time for external managers to identify with our organization's primary objectives in this regard."

As organizations consider their investment allocations, investment management, performance/compliance monitoring and operational efforts in the years ahead, the opportunity to align their purpose with what they do and how they do it will likely continue to rise — as will pressure from data that increasingly correlates value and values around the incorporation of ESG factors.

> "The question of how you invest is almost inseparable from the question of who invests for you."

Silent or silenced: "greenhushing" emerges

If managers once were concerned about greenwashing accusations, they now are watching out for what the industry deems "greenhushing."

The term signifies when ESG considerations are still part of a manager's investment principles but are withdrawn from public comment for fear of the political reprisals, or even divestiture by asset allocators from U.S. states where ESG consideration is under intense pressure if not already banned.

A report issued by South Pole indicates precisely that sentiment, with nearly a quarter of the 1,200 firms it surveyed not planning to publicize their science-based emissions targets.

This is in direct contrast to other regions like the Eurozone, where regulators and allocators demand greater incorporation of ESG principles. Likewise, Canadian market regulators and industry associations are observing a significant increase in the number of investment fund managers that are disclosing ESG factors and strategies in the prospectuses of their funds. The Canadian Securities Administrators recently provided an update on their ESG-related investment fund disclosure guidance in response to the influx of interest in ESG investing.

According to a report from the Global Sustainable Investment Alliance, compared to other regions such as the United States, Japan and Australasia, Canada experienced the largest increase in sustainable investment assets over the preceding two years, with 48 per cent growth, and at the time of the report, Canada was the market with the highest proportion of sustainable investment assets at 62 per cent.

Similarly, according to a report from the Responsible Investment Association, retail responsible investing mutual fund assets had increased from $11.1 billion to $15.1 billion, an increase of 36 per cent over two years. In 2021, the value of "sustainable funds" in Canada was $18 billion at the end of the first quarter, representing a 160 per cent increase from 2020, and there were 156 sustainable funds at the end of March 2021 as compared to 105 at the same time the prior year.

Many institutional investors are at a tipping point as the value proposition on ESG continues to rapidly change and develop. As more organizations consider how to incorporate ESG into their everyday processes, they will still be faced with challenges in determining which sources of ESG best align with their investment approach. Therefore, looking ahead, we anticipate continued and evolving discussions with our clients on their approaches.

48%

growth in sustainable investment assets in Canada.

62%

sustainable investment assets in the Canadian market.

160%

increase in the value of "sustainable funds" in Canada since 2020.

Sources:

CIBC Mellon research – www.cibcmellon.com/takingcontrol

CIBC AM Paper - https://www.cibcmellon.com/en/_locale-assets/pdf/straight-talk/2023/st20230418-investing-private-market-alternatives.pdf

South pole – net zero and beyond https://www.southpole.com/publications/net-zero-and-beyond

GSI - https://www.gsi-alliance.org/trends-report-2020/

Questions to ask going forward:

1. How are you managing portfolio risk with multi-asset class portfolios?
2. How do you ensure full transparency into your assets if you have a 10, 20, 30 per cent allocation to alternatives?
3. How will you navigate diverse or even directly conflicting mandates from various stakeholders around ESG?

For more information

CIBC Mellon is pleased to engage with clients on this front and continue the conversation. Please contact your Relationship Manager if you would like more information.

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