The Case for Private Market Investments

By David Baker and Brian Whitaker

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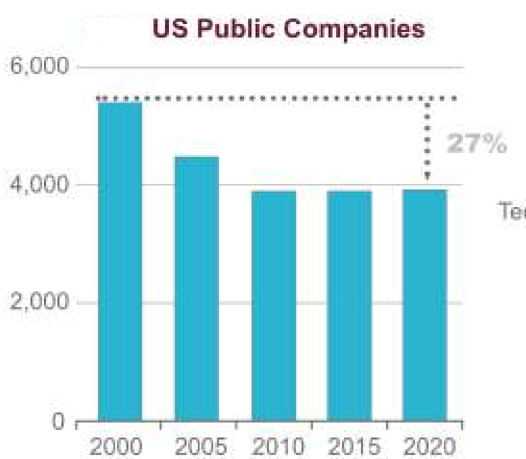
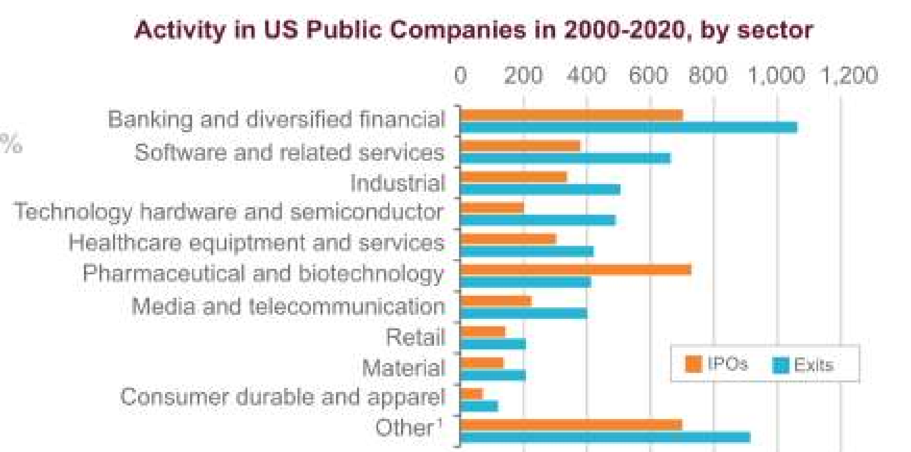
As wealth advisors, we are continually aiming to expand the "opportunity set" for clients, meaning finding and proposing investments that offer atypical sources of return. Increasingly, an area of focus for us is private market investing, as we foresee lower average returns in the public stock and bond markets given current valuations and global growth concerns.

Private investments are just that: any investment that is not publicly traded. Many of our clients already have significant stakes in the private markets through ownership of a closely held business, investment real estate or other assets. For them, as well as clients invested solely in the public markets, we assess how diversification into different types of private market investments can benefit their portfolios, given the following:

Public markets are offering less diversification than in the past. As the chart below shows, there are roughly 27% fewer publicly traded US companies now than in 2000 (and close to 50% fewer than in 1980), even as the total value of publicly traded stock has risen significantly, to 150% of GDP (see chart on next page). There are many reasons for the "fewer and bigger" shift in the US public equity markets. For one, industry consolidation. Just as key, not as many companies are going public via Initial Public Offerings (IPOs), since funding is readily available from venture capital groups and private secondary offerings. In most major sectors, there have been fewer IPOs since 2000 than exits (sale of company shares to other investors in the private markets), resulting in more of the gains in equity valuations going to private market investors.



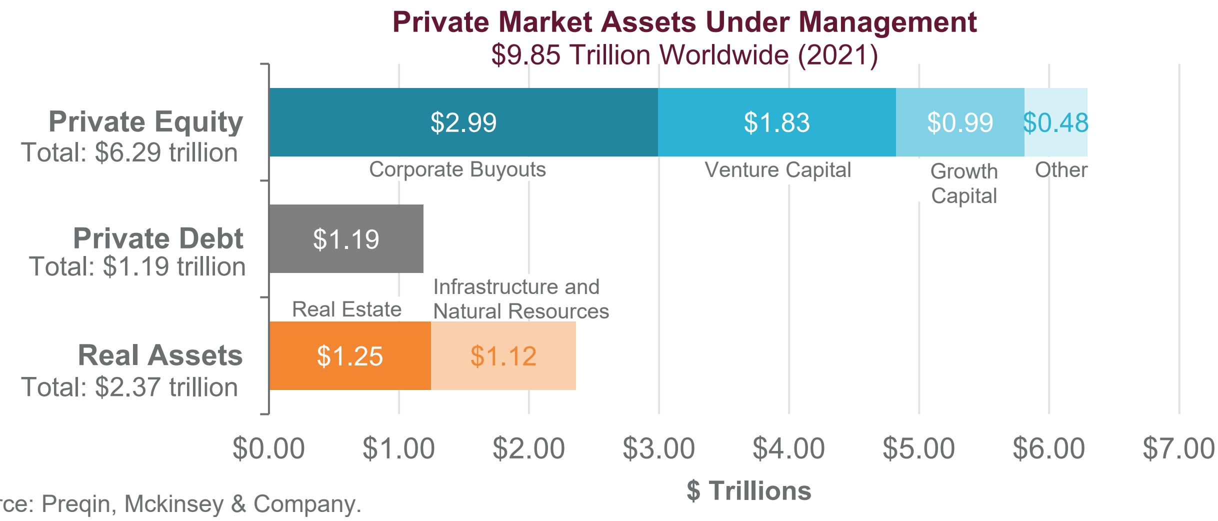
Source: S&P Global; Corporate Performance Analytics by McKinsey.



[1]Includes energy, insurance, household and personal products, real estate, services, and utilities.
Source: S&P Global; Corporate Performance Analytics by McKinsey.

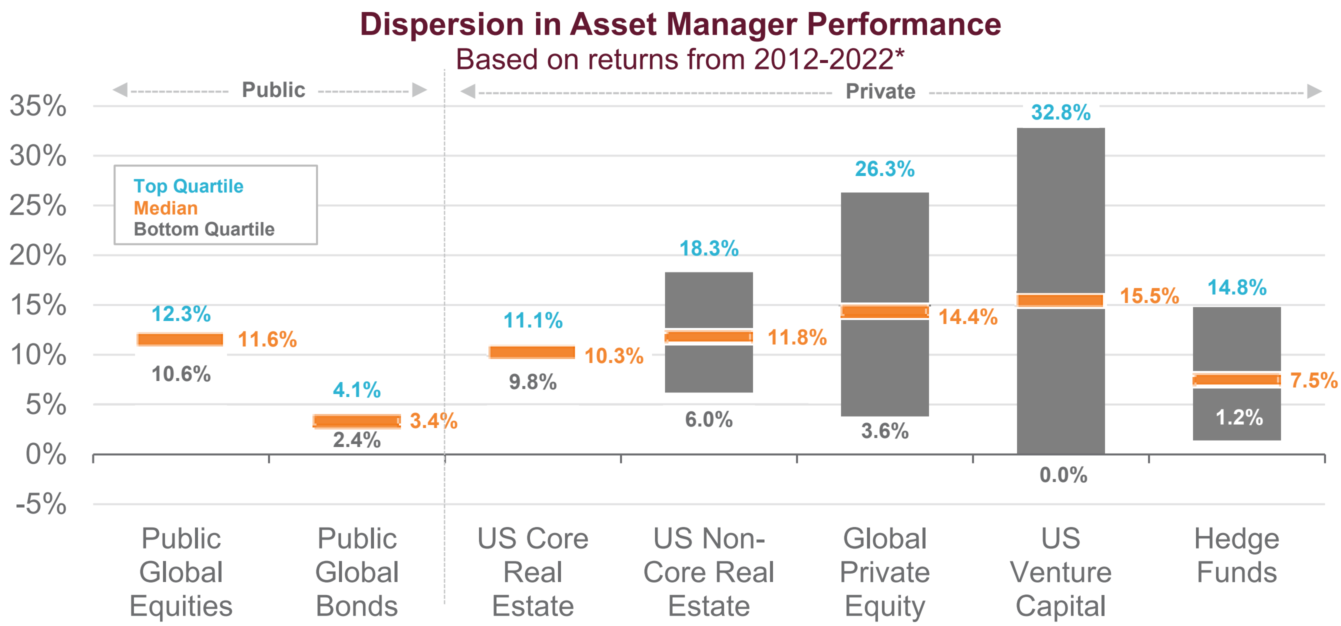
Increasing number of opportunities in the private markets. Many more companies are attracting private equity investment, and new money flows into all private markets increased steadily from 2013 through 2021. This money has not just gone into private equity deals. Investment in private market bonds and other private debt has also risen substantially, offsetting banks as a source of funds.

In fact, private debt, natural resources and infrastructure have seen the fastest growth among private markets in the past five years.



Source: Preqin, Mckinsey & Company.

Much greater dispersion of returns in the private markets. This is to be expected since there is greater diversity in the quality and quantity of private investments, which is particularly true for private equity investments. As the chart below shows, the distribution of returns for private global equity funds from 2012 to 2022 ranged widely — from +3.6% to +26.3% — significantly more than the narrow band of returns for publicly available global equity funds.



Source: Lipper, NCREIF, Cambridge Associates, HFRI, J.P. Morgan Asset Management.

Global equities (large cap) and global bonds dispersion are based on the world large stock and world bond categories, respectively. "Manager dispersion is based on the annual return for global equities, global bonds, US. Core real estate and hedge fund returns over a 10 year period ending 4Q 2021. US non-core real estate, global private equity and US. venture capital are represented by the 10-year horizon internal rate of return (IRR) ending 3Q 2021. Data is based on availability as of February 28,2022.

Concentrated ownership with long-term focus. Investments in the private markets are often illiquid – capital is committed for five to 10 years. This makes it possible to invest in ventures that are not immediately profitable nor can they be sold quickly but which could generate attractive returns over a decade or so. By contrast, public markets are usually highly liquid but focused on the short term, with significant investor emphasis on quarterly earnings and meeting shareholder expectations. Less likely in the public markets are long-term strategies that create value but in the near term can put a strain on financials (lower profits, diluted earnings, higher debt levels, etc.).

Potential alignment with personal values, interests and preferences. Because of the wide range of investments in the private markets, you have more opportunity to focus on specific areas of interest, especially if you want to have your investment benefit society, such as funding to produce renewable energy or affordable housing.

Key Considerations

At LNWM, we research and seek out private market investments with good risk/reward profiles — including private equity funds, growth capital/venture capital, private real estate, private infrastructure, natural resources, distressed debt — while also helping clients to evaluate private investment opportunities in context of everything else they own.

Below are key considerations before proceeding with any private market investment, so that you can make a decision that works best for you. Helping clients see how an investment aligns with their goals, finances and wealth plan is just as important for us as finding the right investment in terms of risk and return.

Liquidity

As mentioned earlier, private investments require that you commit capital for an extended period of time, an average of five to 10 years. This makes private investing "illiquid" by definition. While you could potentially sell your shares in a secondary offering, those transactions are complex and the number of buyers limited, possibly resulting in steep discounts to intrinsic value.

We do not think lack of liquidity translates into higher risk, unless: (1) The level of due diligence on the investment is sub-par. Here at LNWM, we apply an even higher level of screening and vetting to private investments given the lack of public data available and the long-term commitment of capital. We do not invest unless we have strong conviction about the management team and their investment plan.

(2) Your need for liquidity was miscalculated. Getting an accurate estimate of your liquidity needs requires an in-depth income sustainability analysis for the next several decades, considering all likely expenses and aspirations, so that you feel confident you can live the life you want without access to the money tied up in the private investment. After conducting an income sustainability analysis for many different life events and scenarios, we often find that clients actually have more liquidity than they think (even with a large buffer for unexpected events); therefore, they are financially able to capture the "illiquidity premium" provided by private markets.

Some positive aspects of illiquid investments: You will not be able to act on the urge to sell during market downturns, which often results in locking in losses. Also, private fund investments happen in stages, as the general partners raise capital for new investment. These capital calls can provide a natural "average-in approach" to investing. Similarly, private funds seek to sell portfolio investments when attractive opportunities arise, providing a natural sell discipline. During market downturns, the General Partners of well-positioned private funds are often able to take advantage of lower prices with their "dry powder" — funds raised but not yet invested.

Taxes

The money you invest in private markets is taxed according to the type of entity you invest in. Some private market investments, such as angel financing for a startup, provide a tax advantage if they do not generate income or dividends annually, and you pay a long-term capital gains rate when you sell, which in certain cases can be eliminated if the shares you were allotted are Qualified Small Business Stock (QSBS).

However, most private funds are set up as Limited Partnerships or Limited Liability Companies, which are required to report annually your portion of income generated, whether or not it is distributed. Usually, that reporting is done via a Schedule K-1, which is issued to you to report on your federal tax return. While K-1s can be cumbersome, we have experience integrating them into our client's investment tax reporting.

Family Circumstances

What happens if you get married or divorced during the time that your money is tied up in a private market investment? It is important to know (and prepare for) the rules of community property and how those would apply. In nine states, including Washington and California, whatever investment is made during the marriage belongs to both spouses equally, with few exceptions.

Estate Planning

What happens to your private market investment if you pass away? There are many trust and estate planning strategies you can use to specify what happens to your assets, including private market investments, while increasing tax efficiency and privacy. For instance, you could specify in your will that upon your death, your private market investment will be placed in a trust for certain family members and/or organizations, and you can specify the terms under which the trust would disperse the assets.

Are You Qualified or Accredited?

Because private investments are not required to register with the SEC (Securities & Exchange Commission), investors in private market funds must meet certain net worth thresholds. Depending on the fund, there are two levels of qualification:

Qualified Purchaser – Someone who owns more than $5 million worth of investments.

Accredited Investor – Someone whose net worth (excluding primary residence) is higher than $1 million, or whose earned income is above $200,000 a year ($300,000 if married) for at least the past three years.

Note that qualified or accredited investors can be individuals, an existing family-owned business or a trust set up by qualified or accredited investors. If a business or a trust, that entity cannot have been formed for the specific purpose of investing in the private fund. Rules and criteria for businesses and trusts may differ; we advise clients to contact their LNWM advisor with any questions.

Context Is Key

We believe private market investments can enhance the overall risk/return profile of portfolios over time. That's because an increasing number of investments are now offered in the private markets, often at attractive valuations; the managers of private funds are incentivized to invest for the long term and in-line with investor interests; and the managers often have more leeway to take advantage of market downturns, since they do not have to address investor withdrawals. As always, the devil's in the details. This is why we dig deep to assess how a private market investment will work in terms of risk and return and also how it aligns with client finances and life goals.

ABOUT THE AUTHORS

David Baker, CFA® is Senior Director, Investment Strategy and Research at Laird Norton Wealth Management (LNWM). Applying more than two decades of experience in investment portfolio management, David leads LNWM's portfolio modeling process, both for strategic and tactical positioning, including the development of capital market assumptions, portfolio optimization, and risk analysis. In addition, he oversees LNWM's research process and the ongoing monitoring of portfolio investments in the public and private markets. He is a Chartered Financial Analyst and has a B.A. in Business Administration from the University of Washington.

Brian Whitaker, CFP® is Senior Director, Client Services at Laird Norton Wealth Management, drawing on more than 20 years of financial services experience to develop customized and comprehensive financial plans that keep clients on track toward their life goals. Brian is especially adept at working with closely held or family owned businesses, advising owners on integrated financial strategies, including business sales/successions and creating family legacies through the establishment of trusts. Brian is a CERTIFIED FINANCIAL PLANNER™ Professional and has a bachelor's degree in economics from North Park University in Chicago, Ill., where he serves on the board of the School of Business and Non-Profit Management.

ABOUT LAIRD NORTON WEALTH MANAGEMENT

Laird Norton Wealth Management ("LNWM") has long partnered with its clients to help them achieve their greatest impact through their investments, legacy planning and philanthropy. Founded in 1967, LNWM is both an RIA (registered investment advisor) and trust company, providing comprehensive and integrated wealth planning to individuals, families, business leaders, private foundations and nonprofit organizations nationwide.

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