

# Modern diversification

Capturing themes in private markets



# A world in transition

Investors around the world are faced with the uncertainty of inflation following a sustained period of both fiscal and monetary stimulus. More recently, emerging geopolitical conflicts are adding to volatility, and investors are increasingly concerned about elevated valuations across multiple asset classes. All this is happening at a time when investors are trying to position their portfolios for the transition to a lower-carbon economy.

In this three-part series, *Capturing Themes in Private Markets*, we translate these developments into relevant themes for investors. Private markets are well positioned to help investors address these challenges through a diverse and innovative range of strategies as they seek to unlock portfolio returns.

We have identified three overarching themes that we believe will impact investment decisions, specifically addressing:

Part 1: Inflation Playbook — How Can Private Markets Manage Inflation?

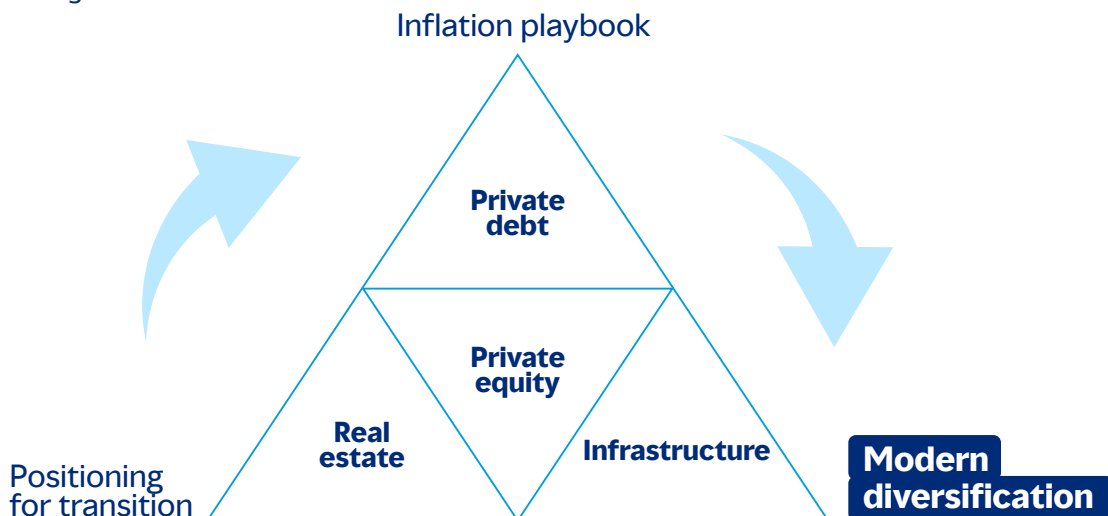
Part 2: Positioning for Transition — How Can Investors Pursue a Sustainable Path Without Missing Out on Returns?

## Part 3: Modern Diversification — How Do Investment Themes and Innovative Companies Bring Diversification to a Portfolio?

Effective solutions to new challenges are rarely found in the past, and investors looking for solutions to their own portfolio challenges can also look forward to meet their obligations.

To find the answers to conundrums the world will face in the coming years and decades, we need to focus through the vital lens of innovation — and it can be most abundantly found in private markets.

Covering an entire international spectrum of industries, sectors and companies of all sizes, investors in private markets can employ a diverse combination of asset classes and investment themes to manage risks and seize opportunities. In this article, we delve into the myriad choices investors have before them and how skillfully blending them within portfolios may produce valuable results.



# Modern diversification — How do investment themes and innovative companies bring diversification into a portfolio?

## Beyond beta: Private markets — The roadmap for modern diversification

### **Private capital markets have evolved to become to a major force in driving innovations.**

They have become highly responsive to the needs of the marketplace while concurrently providing patient capital that allows innovative businesses to take a long-term view on growth.

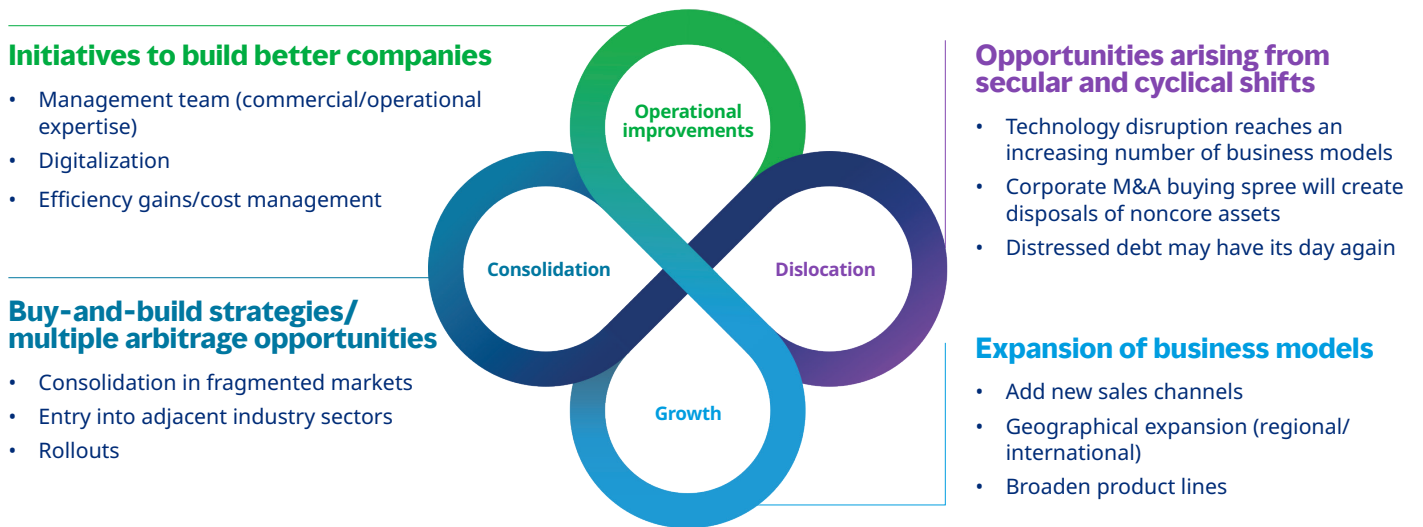
Private markets are enabling investors to access technologies and strategies that are addressing some of our most pressing societal challenges. Furthermore, private markets can offer access to innovative investment opportunities while sidestepping much of the volatility distracting listed companies as they endeavor to implement change.

Beyond the traditional private markets growth story that plays out predominantly in the venture capital space, investors have the opportunity to diversify across economic and business cycles, accessing alpha through operational improvements, consolidations and dislocation.

A major macroeconomic shift is playing out right now. With the return of inflation, many investors are living in a new world. The traditional 60/40 portfolio that has served investors well for decades has become outdated, and the path to generating higher returns is far more nuanced. Moreover, alpha generation is more critical, with market concentration increasing in public markets, whereas true long-term risk premia may prevail only in private markets.<sup>1</sup>

With these changing dynamics in capital markets, investing in innovation and focusing on longer-term objectives could be rewarded. Although public equity and bond markets are, by nature, volatile, innovative companies with distinctive assets may continue to thrive no matter the economic backdrop. Investing in such companies can improve diversification in your overall portfolio.

**Figure 1. Investment themes that can drive value in today's private markets**



Thematic investing is key to unlocking value. Below, we explore some of the opportunities we see in private markets.

• **Private equity**

Healthcare, financial services and technology are the three main industries attracting capital. Traditionally, inflation-sensitive sectors, such as energy, industrials and healthcare, could see greater deal activity in light of the inflationary environment.

– **Healthcare**

We have seen huge advancements in private-equity-backed **biotech companies**. These companies are investing in areas such as gene sequencing — to help identify medicines or vaccinations against a specific disease — or precision medicine, which can identify drugs personalized to each individual.

**Medtech businesses** offer solutions for diseases linked to aging, such as more-efficient hip replacements or customized contact lenses that adjust to your eyesight needs as you age. Advances in specific fields will enable localized drug delivery or a chip in your body that targets a drug to the specific part of your body that requires treatment.

**Health and wellness** includes improvements in healthcare delivery, such as healthcare via Zoom, and more consumer-focused wellness solutions, such as health, exercise and wellness apps.

– **Fintech**

Disruptive technologies are providing an alternative to the traditional ways of doing business along with different ways of paying for goods and services; for example, solutions simplifying corporate credit card and expense management, software to make it easier to switch deposit accounts, mortgage management tools and other personalized banking functions.

– **Technology**

Some of the most innovative and successful venture-capital-backed technology companies were born during market downturns. As big tech company valuations have fallen along with employee stock options, many talented engineers are leaving to launch startups.

Technology transformation continues across industries (for example, tech-enabled solutions for traditional industries and business processes). Deep tech is becoming localized as a result of technology decoupling (for example, semiconductor). And clean-tech is becoming accessible at more reasonable pricing levels as availability of funding is reduced.

• **Infrastructure**

The infrastructure asset class is well positioned to address both short-term (liquefied natural gas facilities) and long-term (renewable power) energy demands, which have been exacerbated by the additional pressure from the Russia/Ukraine conflict. Additional innovation continues to emerge:

- **Digital transition** — Alongside energy transition, digitalization and high demand for cloud services, 5G, and data storage will continue to provide tailwinds for telecommunication and digital assets in general. The internet could soon be seen as the fourth utility.
- **Hydrogen production** — Both “blue” and “green” hydrogen are expected to see increased investment as energy security takes precedence. End uses include power generation and transportation.
- **Advanced construction methods**
  - **Intelligent software solutions**  
Viewable infrastructure projects in 3D help to optimize design, ensure greater cost predictability and enable the delivery of projects on time and on budget.
  - **Internet of things**  
Technological advances can be used to physically construct components of an infrastructure project.
  - **Mass timber**  
Gluing timber sheets together to create a stronger material is increasingly replacing materials like cement and steel, which will enable the era of wooden skyscrapers. Vienna’s HoHo tower will be 24 stories high, and Norway recently completed an 18-story tower (Mjosa Tower), which is currently the tallest timber tower in the world. Using mass timber can reduce construction time by up to 25% and is much less carbon intensive than using steel or cement.
  - **Plastic roads**  
We’re seeing some firms develop plastic roads using recycled material from disposable plastics. Some Dutch cities are using this approach to build cycle paths, and, one day, it may be used for roads and highways.

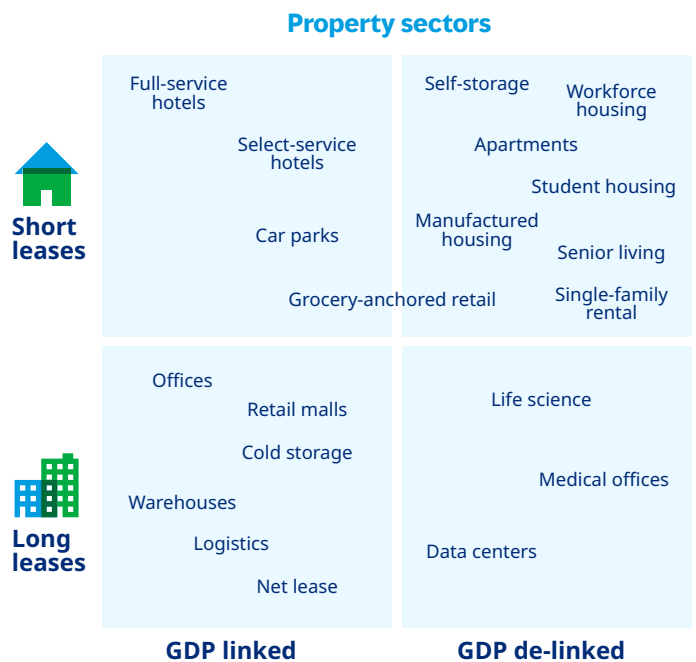
• **Real estate**

The built environment is responding to long-term trends such as an aging population, generational shifts, increasing digitalization, e-commerce and higher ESG requirements. Logistics, various living sectors and other niches are benefiting from these structural trends. Alongside these trends, the real estate sector has evolved significantly, offering a deep pool of investment opportunities.

Some of the opportunities include:

- **Data centers**
  - The increasing importance of the digital economy has allowed many corporations to bolster their IT infrastructure capabilities and continue to migrate to cloud-based services.
  - The main layer of current growth can be attributed to increased consumption of internet videos and services and increased mobile demand. Although demand growth has been outsized during the pandemic, long-term growth in developed markets has been above 20%.

Figure 2. Core real estate characteristics





- Future demand growth is forecast from further adoption of cloud computing, integration of 5G, the internet of things, self-driving cars, and other artificial intelligence and similar technologies that rely on machine learning.

#### – **Self-storage**

The primary demand drivers for storage space are life-changing events, including downsizing, household formations, divorces, deaths, moving homes and renovations. These events happen under all economic conditions.

#### – **Studio space**

Due to the rapid growth of digital streaming networks and associated consumer demand for new and original content, studio space supply has become significantly constrained. The ease of streaming content from personal devices has buoyed demand for this space.

#### – **Life science | R&D**

The main driver for increased demand for life science R&D space is attributed to an aging population — 30% growth is expected in the 65+ cohort by 2030<sup>2</sup> — and rapid technological advancement, as evidenced by the development of the COVID-19 vaccines.

#### – **Single-family rental (SFR)**

SFRs saw a sharp uptick following the global financial crisis when housing affordability concerns pushed many homeowners back to renting.

### **Private debt**

The private debt space develops alongside the previously outlined innovation activities. Major opportunities are still evolving in the non-bank-lending space, specifically in Europe, and in other areas globally, such as structured credit and specialty finance, which can add diversification within portfolios. Additionally, private debt plays a major role to finance the infrastructure gap.

### **Diversification through portfolio design and product innovation**

Innovation diversification benefits go far beyond company-specific value creation. Portfolio design and product developments have evolved significantly.

This includes the growing range of open-ended solutions in real estate, infrastructure equity and private debt, giving investors the potential for liquidity in private markets.

Private debt managers give investors the flexibility to decide on an interval basis (say, every two years) whether they want to let the loans in the portfolio run off to give them liquidity or whether they wish to roll over their investments for a further period. Also, open-ended and evergreen structures can help overcome portfolio management challenges.

Within private equity, we are continuing to see growth in secondaries, with more and more managers launching continuation funds that allow investors to hold on to some of the star performers in their portfolios. This is helping investors mitigate the J-curve effect, reduce blind pool risk, enhance diversification, accelerate exposure buildup and see an earlier return of capital.

# Key takeaways

Traditionally, investors turn to private markets to seek return opportunities and diversification.

As investors continue to increase their allocations to private markets, they are also finding added benefits. Private markets investments provide elements of inflation-protection hedging in investors' portfolios. They also offer a diverse range of opportunities to meet investors' sustainable and impact goals while aiming to deliver a higher return profile than with public markets. In addition, investors can achieve enhanced diversification by investing in managers with innovative strategies at companies that are leading change in their sectors.

The opportunity set in private markets is deep. It is therefore important to diversify across a range of managers using a variety of strategies. The starting point is an effective portfolio construction process to identify the themes and opportunities that investors plan to capture. Investors should also apply a rigorous due diligence process to ensure a balanced blend of strategies diversified across geographies, sectors and vintage years.

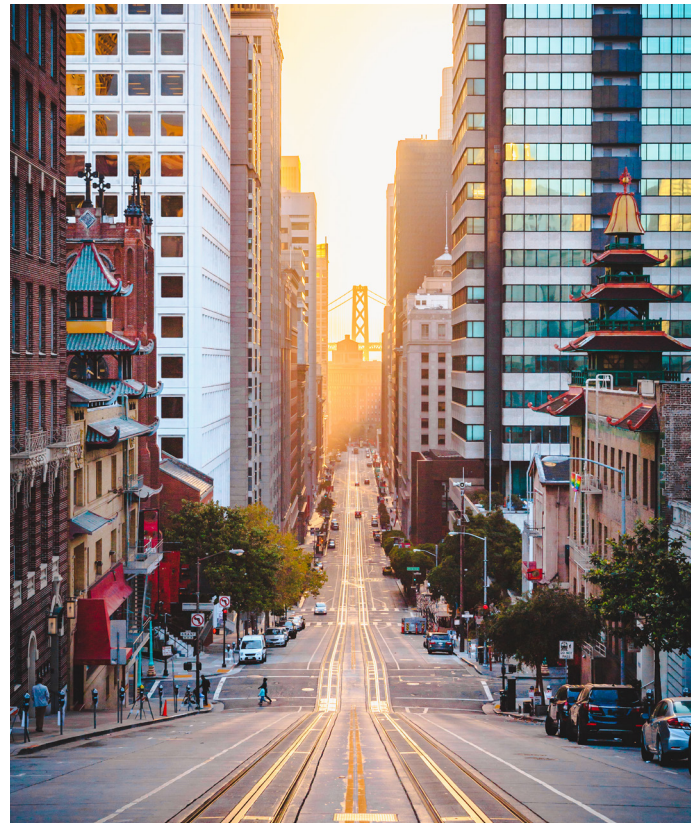
Despite recent market volatility, future growth in private markets looks strong. Experts predict that private equity assets under management (AUM) will grow at 16% per annum (p.a.) between now and 2025 to US\$10 trillion, with private debt expected to grow by 11% p.a.<sup>3</sup> Similarly, strong AUM growth is expected in infrastructure equity and real estate.

Macroeconomic headwinds, such as inflationary pressures and more modest growth prospects, are foremost on investors' minds. The transformational investing approach of private markets, which combines thematic sourcing with value creation, can help investors navigate this environment.

In parts one and two of this three-part series, *Capturing Themes in Private Markets*, we look at:

**Inflation Playbook — How Can Private Markets Manage Inflation? Inflation Reaches a 40-Year High in 2022**

**Positioning for Transition — How Can Investors Pursue a Sustainable Path Without Missing Out on Returns? Start to Change the World With Your Investments**



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## Endnotes

<sup>1</sup> Mercer. *Public and Private Markets in Transformation*, 2019, available at <https://src.us-east-1.prod.awsapp.mercer.com/v1/api/uploads/c61ebf764929432baf56bcaa827d3db4.pdf?public=false>.

<sup>2</sup> United Nations Population Division 2019; Mercer.

<sup>3</sup> Prequin. *The Future of Alternatives 2025*, December 2020.

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